THE PRINCIPLES OF AUDITING

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THE PRINCIPLES OF AUDITING

A PRACTICAL MANUAL FOR STUDENTS AND PRACTITIONERS

BY

F R M de PAULA, O B E, F C A

LATE SIR ERNEST CASSEL PROFESSOR OF ACCOUNTANCY AND BUSINESS METHODS IN THE UNIVERSITY OF LONDON

TENTH EDITION

Reprinted with additional Appendix

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FOREWORD

By SIR J GEORGE BEHARRELL, D S O

THIS is the third occasion I have had the pleasure of writing a foreword to a new edition of "Principles of Auditing" I feel much honoured to be asked to write a foreword to the Tenth Edition

The frequency with which new editions are called for is the best possible tribute to the popularity of the book and to the keen desire to study the new additional features which the Author has felt it necessary to incorporate in each succeeding edition

It seems to me to be a clear indication that accountants are more than ever realizing their great responsibilities, the supreme importance of which, to the business world in present difficult and changing conditions, is undoubtedly greater than ever before

The form of the presentation of accounts is still an outstanding question, but as more and more study is given to the problem, there becomes apparent a gradual and definite improvement to the advantage both of management and the investing public

The trail which the Author has blazed is securing more and more followers and, as a result of further discussion and experience, I sincerely hope that the presentation of the accounts of holding companies may be further improved and standardized rather by consent than by force

All the additions to the new edition are important and extremely helpful

J GEORGE BEHARRELL

ST JAMES'S HOUSE,
ST JAMES'S STREET,
LONDON, S W 1
1938

PREFACE TO THE REPRINT OF THE TENTH EDITION

SINCE the publication of the Tenth Edition of this book the outstanding event in the world of Accountancy, apart from the war, has been the publication by the Institute of Chartered Accountants in England and Wales of a series of recommendations regarding accounting principles.

When, therefore, my publishers informed me that the stock of the present edition was fast running out, my first impulse was to re-write the parts of the book affected by the Institute's recommendations, but in the first place the recommendations published to date are closely in line with the existing text of this book and also the series of recommendations is by no means complete. Furthermore, the whole text will require extensive re-writing in the near future upon the amendment of company law as a consequence of the recommendations of the Cohen Committee.

Apart from the foregoing considerations my publishers strongly urged reprinting the existing edition owing to technical war-time difficulties. It was therefore decided to reprint, but in order to bring the book up to date there has been added an Appendix "C" containing a reprint of the Institute's recommendations referred to above. This will enable the reader to compare the original text with these recommendations, and thus obtain a clear view of what is regarded as the best current practice.

I wish to take this opportunity of thanking sincerely the Council of the Institute for kindly agreeing to the inclusion of these recommendations in Appendix "C."

F. R. M. de PAULA

8 PALACE GATE
LONDON, W 8
DECEMBER, 1944

PREFACE TO THE TENTH EDITION

SINCE the publication of the last edition of this book some twelve months ago, the most important event in the world of Accountancy has been the holding of the fifth International Congress on Accounting in Berlin, during that eventful month of September, 1938

At that Congress, particular attention was directed to the all-important subject of the accounts of holding companies The papers submitted upon this subject are well worthy of close study

I have taken this opportunity to revise carefully Chapters XIII and XIV, which deal with the accounts and audit of holding companies, in the light of the discussions on this subject at the recent International Congress

In particular, in Chapter XIV, I have introduced a new section in which I have attempted to define the general principles governing the valuation of shares in, and advances to, subsidiary companies

It is now some ten years since I first advocated the inclusion in the Appropriation Account and the Balance Sheet of proposed dividends There are differences of opinion on this point, but in recent years an ever-increasing number of companies have adopted this form of presentation I have taken this opportunity to rewrite the section in Chapter XIII dealing with this subject By kind permission of the Editor of *Accountancy*, this revision is based upon an article which I wrote for that Journal and which appeared in the issue for October, 1938

As regards the unorthodox views upon the subject of the valuation of inventories which I originally put forward in the Eighth Edition (Chapter VI), I have carefully reconsidered the whole of this chapter, in the light of subsequent discussions which I have had with many accountants and industrialists I have made minor alterations and additions, but I have not altered the main line of argument

I have dealt, in this edition, with the recent case of *Brown* v *Gaumont British Picture Corporation*, which raises an important question of interest to Auditors

In Appendix "A," I have substituted the 1937 Reports and Accounts of the Dunlop Rubber Company, Ltd, Dunlop Cotton Mills, Ltd, and Dunlop Plantations Ltd, in place of those for the year 1936

Once again I wish to take this opportunity of expressing my most sincere thanks to Mr Sidney H Mearns, C A, of Messrs Whinney, Smith and Whinney, for the invaluable help that he has afforded me in connexion with this book during the many years of our association and friendship

I also wish to thank most sincerely my old friend Sir George Beharrell for again so kindly writing the foreword

F. R. M. de PAULA

ST JAMES'S HOUSE
ST JAMES'S STREET,
LONDON, S W 1
1938

PREFACE TO THE EIGHTH EDITION

THE publication of this edition coincides as nearly as possible with the coming of age of this book, the first edition of which I wrote in the early part of that fateful year 1914

I have taken advantage of a business journey round the world, involving many long weeks at sea, to think out anew the whole of the text, and to bring it all up to date, and, I hope, in line with modern thought and practice In order to effect this I have had to expand the book from the original ten chapters to fourteen

Looking back over the twenty-one years which have elapsed since the book was first written, one cannot fail to feel greatly impressed with the profound changes and developments which have occurred in the world of Accountancy

One very remarkable feature has been the rapid growth and development of the profession all over the world In fact, this trend has been one of the most notable evolutions in industry and commerce during the past generation At the same time the outlook of accountants has, in some directions, entirely changed Perhaps no event throughout the whole period has had so profound an effect on the views of the profession as the *Royal Mail Steam Packet* case, which undoubtedly will be regarded in the future as an outstanding landmark

In 1933 there was held in London the International Congress on Accounting, which gave the profession an ideal opportunity to take stock of the position as regards this and other vital matters

In my opinion, the proceedings of that Congress represent a contribution of the first importance in the world of Accountancy They reveal clearly that the profession is moulding definite principles in regard to the serious problems involved in the *Royal Mail Steam Packet Company* case

The evolution and development of the holding company has created very difficult and complicated questions in

connexion with the form of presentation and the audit of the accounts of these companies When I was a student we heard nothing of these matters, but to-day they are burning problems about which every accountant should have knowledge

I have, therefore, added two entirely new chapters, one, Chapter XIII, dealing with the form of presentation of the accounts of holding companies, and the other, Chapter XIV, dealing with the main points arising in connexion with the audit of those accounts The former is based upon a lecture which I delivered at Birmingham University and before various of the Chartered Accountants Student Societies

In Appendix A the 1934 Report and Accounts of the Dunlop Rubber Company, Ltd , are shown The form of presentation of these Accounts, with the designing of which I was intimately concerned, has I think broken new ground and answers many of the criticisms which have been directed against the common form of presentation For this reason I feel that readers may be interested to study this Appendix in conjunction with Chapter XIII

For some time I have been disturbed by the fact that in practice so many different bases are utilized for the purpose of the valuation of inventories We have an accepted slogan that the basis should be the lower of cost or market value, but the profession collectively has not attempted to define what precisely is meant by either cost or market value

The valuation of inventories is a matter of such vital importance that obviously every effort should be made to secure agreement upon basic and uniform principles for the assistance and guidance of industry and practitioners

I have, therefore, endeavoured to think this problem out afresh and to suggest basic principles This I have done in a new Chapter VI In some directions the principles I have suggested are diametrically opposed to accepted practice and therefore many may not agree with them. If, however, this attempt to establish basic principles leads to a general discussion upon this vital matter, then it will have been well worth while, for the subject is one which urgently requires the careful consideration of the profession

I have also for many years been worried by the fact that

there are in use so many different methods for the calculation of depreciation, all of which give different results In Chapter VII I have discussed this problem fully I do feel that this also is a matter upon which the profession should make up its mind

The chapter upon the legal position of auditors had become unduly long owing to the addition from time to time of recent cases I have, therefore, split this chapter into two, Chapters XI and XII

Throughout this book I have endeavoured to reflect the latest views of the profession by quoting from and referring to the most important and representative papers given at the recent congress and elsewhere, thus I hope enabling my readers to obtain a clear view of the opinions held by the leaders of the profession upon the problems that are perplexing all of us

Wherever I feel my own views to be unorthodox I have called attention to the fact, and have endeavoured to state clearly the traditional view as well as my own

I have also revised the set of examination papers appearing in Appendix B in order to bring them up to date and I have added a number of questions upon holding companies The total number of questions has grown since the first edition from one hundred to one hundred and fifty

I am glad to take this opportunity of expressing my most sincere thanks to my friend Mr Sidney H Mearns, C A , of Messrs Whinney, Smith & Whinney, for the invaluable help that he has afforded me in connexion with the additions to and revisions of this edition Mr Mearns has most generously given me the great benefit of his wide experience, and sound advice

I also wish to thank my old friend and colleague, Sir George Beharrell, most sincerely for so kindly writing a foreword

I hope that in its enlarged and revised form this book will be helpful to readers, from whom I shall always be pleased to receive suggestions for its improvement

F R M de PAULA

ST JAMES S HOUSE,
ST JAMES S STREET,
LONDON, S W I
1936

PREFACE TO THE FIRST EDITION

THE subject of Auditing is so vast that the standard works, of necessity, are somewhat lengthy and cumbersome books, and a considerable part of the matter contained therein is intended for practitioners only This book has been written primarily for students, with the object of providing a book of convenient size, and at a reasonable cost, that will deal with all the general principles that govern every audit, and so form a stepping-stone to the larger works

I have endeavoured to cover the whole of the ground-work with which every student of auditing must be familiar and to explain the principles and reasons underlying each subject dealt with On the other hand, owing to lack of space, I have omitted specialized subjects, such as the different classes of audits and investigations, for if all these were included the whole book would have had to be condensed so considerably that it would have been impossible adequately to discuss the important root principles that apply to every audit For the same reason all the various Acts of Parliament to which auditors have at times to refer have been omitted, but the sections of the Companies Act, with which every auditor must be familiar, have been included

The appendix contains one hundred examination questions, which run in order with the text of the book, and it is thought that these will prove of value to students for the purpose of testing their knowledge with a view to preparing for examinations

I would take this opportunity of thanking most sincerely Mr Herbert Jacobs, B A., Barrister-at-Law, and Mr David W. Coates, M A, LL B, A C A, for the very valuable assistance that they have afforded me

I shall appreciate greatly any suggestions or opinions from readers, whom I hope this book may assist to acquire a thorough and practical knowledge of the principles of auditing

F R M de PAULA

1914

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THE PRINCIPLES OF AUDITING

CHAPTER I

INTRODUCTORY

THE practice of auditing can be traced back to ancient times, but the accountancy profession as it exists to-day was established only in the latter part of the nineteenth century For example, the Institute of Chartered Accountants in England and Wales was incorporated by Royal Charter on the 11th May, 1880

In this country, during the nineteenth century, industrial enterprise was greatly expanded owing to the coming of the steam age and the consequent mechanization of industry The evolution of the mechanized factory involved the provision of finance far in excess of that required by industry under the old-fashioned hand methods

Originally individual concerns were owned and financed by either a sole proprietor or a partnership, and naturally under this type of organization the finance and credit available was limited to that which the owners themselves could provide and influence For this reason, therefore, the capital available for industry was strictly limited.

The introduction of the joint stock company greatly widened the possibility of raising capital for industry As the liability of each shareholder was limited, it was possible to offer shares to the public and thus industry opened up a vast supply of capital Thus in course of time the joint stock company largely took the place of the small privately owned business

Under the company form of organization the shareholders as a body delegate the management of the undertaking to a Board of Directors and periodically the Board submits to the shareholders the accounts of the company in order that the members may be enabled to see the financial position

of and the progress of the undertaking in which they are interested

In these circumstances the need arose for some means by which the shareholders as a body might be satisfied that the accounts presented to them by their Board of Directors did in fact show a true and correct view of the financial position of the company It was for this reason, therefore, that the practice developed of appointing an auditor whose duty it was to verify on behalf of the shareholders the accounts of the Directors and to report thereon to the shareholders Obviously it is impracticable and impossible for every shareholder of a company to examine the books and records of a company and therefore the shareholders as a body appoint an auditor to act for them

In the early days the auditor appointed was generally a shareholder of the company As however the auditor commonly had no technical qualifications he was not able to carry out an effective audit (For this reason therefore the custom developed of appointing professional auditors)

Under the original Companies Acts, a company was not bound to present a Balance Sheet to its shareholders or to have its accounts audited The Companies Act, 1900, first made it legally compulsory for every company to appoint auditors

It was undoubtedly the rapid increase in the number of joint-stock companies that gave the great impetus to the development of the accountancy profession In this country to-day the accounts of practically every public company and the majority of partnerships are audited by professional accountants and in recent years the accountancy profession has expanded greatly in many other directions In consequence accountants have assumed ever-increasing responsibilities and are playing a vital part in the industrial life of the country.

Difference Between Accountancy and Auditing

Originally the work of professional accountants was confined chiefly to the checking of the arithmetical accuracy of the detailed records of transactions in books of account, the agreement of the Trial Balance, and the preparation of accounts; in fact, to what may be described as "accountancy work," but nowadays the all-important part of a

professional accountant's work is that of auditing. The difference between accountancy and auditing is not clearly understood by many business men, it being thought that if accounts are prepared by a professional accountant, he necessarily guarantees their accuracy. This, however, is far from being the case. If an accountant is instructed merely to prepare accounts from a set of books, the work involved would be that of agreeing the Trial Balance, and thereafter preparing the Profit and Loss Account and the Balance Sheet. He would be acting simply as an expert accountant, and not in any way as an auditor; he would ~~not check the books themselves, except~~ as far as would be necessary to agree the Trial Balance, and he would not report that the position shown by the Balance Sheet was correct: all he could say would be that the Balance Sheet was in accordance with the books. Accountants, as experts, are often called upon to deal with figures in this way, but when doing so, they should be particularly careful to point out to their clients that they are not carrying out an audit. And they cannot report upon a Balance Sheet as being correct, unless they have conducted a proper audit of the whole of the transactions of the business.

An audit is quite distinct and apart from accountancy—an audit does not entail the preparation of the accounts at all, but denotes something much wider, namely, the examination of a Balance Sheet and Profit and Loss Account prepared by others, together with the books, accounts and vouchers relating thereto in such a manner that the auditor may be able to satisfy himself and honestly report that, in his opinion, such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the affairs of the particular concern, according to the information and explanations given to him, and as shown by the books. The difference between accountancy and auditing was an important factor in the cases of *Apfel* v *Annan Dexter & Co* and *Leech* v *Stokes and Others*.

An audit of a Balance Sheet involves the verification of the Profit and Loss Account, as the balance of that account must be included in some form or other in the former, and it entails a detailed examination of every item in the Balance Sheet. The auditor's responsibilities as regards

the Profit and Loss Account were raised in the *Royal Mail Steam Packet Co* case, which is dealt with in Chapter X. The Balance Sheet, however, is the all-important document, and is the one to which, in the case of a company, an auditors' report refers and to which it is affixed, for the Balance Sheet contains in summarized form all the balances appearing at a given date in a set of books kept by double entry, including the balance upon the Profit and Loss Account, after the nominal accounts have been closed by transfer to this latter account. The whole of the transactions of a business should be recorded in its books of account, and the combined effect of all such transactions and the whole financial position of the concern, should be reflected in the Balance Sheet, and the primary object of an audit is that there may be an independent investigation with a view to ascertaining whether or not such Balance Sheet shows a true reflection of the financial position of the concern.

In practice auditors often do prepare the Balance Sheet and Profit and Loss Account, which accounts they thereafter audit, but it must be observed that, when preparing the accounts, the accountant is acting as accountant and not as auditor, and that this work is additional to and quite outside his duties as auditor. The duty of an auditor is to check and report upon the completed work of others.

Main Objects of an Audit—Detection of Errors and Fraud

Two main purposes of an audit are the prevention and detection of errors and fraud. Errors may consist of clerical errors, either of commission or of omission, and errors of principle. Errors of commission are comparatively simple to discover, as the ordinary routine checking of the books should disclose them. Under this head will be included incorrect postings, castings, and calculations, mistakes in posting and casting will affect the agreement of the Trial Balance, and their presence will thus be revealed, although the actual detection of the various errors that make up the total difference in the books may entail a considerable amount of detail checking. This work can

be considerably reduced in large businesses if self-balancing ledgers are introduced, as in this way it may be seen at once in which ledgers the errors occur There is no way of exactly locating the errors, except by checking the castings and postings until the discrepancies are discovered Errors in calculations often will not be revealed by the audit, for such mistakes will not affect the agreement of the books for example, if by a mistake in the working out of prices, the wrong amount be extended in the Sales Day Book, this total will be included in the casting up of the Day Book, and hence eventually will find its way to the credit of the Sales Account, while the same amount will be posted to the debit of the customer's account in the Sales Ledger, and so the Trial Balance will not be affected In the ordinary way, it is not considered to be part of an auditor's duty to check the whole of the calculations of the Sales and Bought Day Books, but he should ascertain that these are all independently checked by the staff of the business whose accounts he is auditing, and he should test some of the calculations here and there, in order to satisfy himself that the internal check is being carried out Important calculations such as those dealing with depreciation, reserves, interest on capital, loans, mortgages, etc , however, should be checked

Errors of omission are far more difficult to discover than errors of commission, as the former will not affect the agreement of the Trial Balance, such errors will include the omission to enter invoices in the Bought Day Book, the omission of sales from the Sales Day Book, the non-provision for interest, rent, salaries, and other such outstanding accounts Although the discovery of such omissions, which point will be dealt with at some length later on, forms a very important part of the duty of the auditor, yet in a large business he is compelled to rely to a certain extent upon the internal checks in the business itself to assist him in the performance of this part of his duty If, however, his audit programme is complete and is thoroughly and efficiently carried out, most of such omissions should be discovered. Errors of omission, made intentionally, may affect the results shown by the accounts very considerably, and so constitute a fraudulent falsification of such accounts

Errors of principle may be committed purposely or accidentally, and may affect the accounts considerably, if intentional, they may amount to falsification of accounts, but, on the other hand, they may arise quite unintentionally through lack of a correct knowledge of the principles governing the preparation of the accounts of a business Hence it is necessary that an auditor should have an extensive knowledge of accountancy, and should make a most thorough investigation if he is to discover such errors, which will include, for instance, the incorrect allocation of expenditure as between capital and revenue, the valuation of assets upon an incorrect basis, and the inadequate provision for depreciation and bad debts In this connexion it must be borne in mind that, as a rule, no amount of routine checking will disclose errors of principle—these can be discovered only by intelligent inquiry and research Errors of this nature may make an enormous difference in the accounts, whereas the effect of clerical errors probably will be very small

The detection of errors is a very important part of an auditor's duties, so that the proprietors of a business may feel confident that the accounts are accurate, and that the position of affairs is clearly and correctly shown, but by far the more important part of the auditor's duties is the detection of fraud and its prevention by means of the moral check created by a periodical audit This is the main reason for his appointment in the majority of cases, for instance, the Companies Act, 1929, provides that every company shall appoint an auditor, who shall audit every Balance Sheet that is laid before the shareholders The reason is not that the shareholders necessarily suspect the directors of preparing fraudulent accounts, but that the shareholders as a body have no means of ascertaining how the business is being carried on and what is the financial position of their company, except by reference to the accounts submitted to them by the directors, who conduct the business as the representatives of the shareholders The shareholders, therefore, would be entirely in the hands of the directors, who could, if they were dishonest, make the accounts show whatever position of affairs they chose, unless such accounts were checked independently on behalf

of the shareholders It is for this reason that an auditor is appointed, who acts on behalf of the shareholders, and is absolutely independent of the directors whose accounts he audits The objects of his appointment are to satisfy the shareholders that no fraud is being committed by either the directors or the employees of the business, and to report whether or not the Balance Sheet exhibits a true and correct view of the state of the company's affairs It must not be thought that an auditor should adopt an attitude of suspicion during the conduct of his audit, in fact he should endeavour to avoid creating a spirit of hostility and mistrust between himself and the directors and staff of the company Above all things, he should be tactful His position is that he is there to ascertain that everything is in order, and it is this duty to his employers which he must carry out He need, therefore, adopt no attitude of mistrust, the shareholders are adopting an ordinary business precaution, and have appointed him to see on their behalf that the accounts are in order in all respects, and thereafter he has to report to the shareholders to this effect, or, in the event of his not agreeing that the position shown is the true and correct one, he must state this fact in his report, giving his reasons

Fraud may take the form of either the misappropriation of cash or goods, or the falsification of the accounts unaccompanied by misappropriation Misappropriation of cash may be concealed either by omitting to enter receipts, or by entering fictitious payments In order to discover the first, the auditor must check the receipts shown in the Cash Book with original records, such as till books, salesmen's desk books, cash diaries, counterfoil receipt books, agents' returns, etc , only by comparing original records with the cash accounted for in the Cash Book can such discrepancies be revealed Fictitious payments will be discovered by a careful examination of vouchers, invoices, wages sheets, and other direct evidence of this nature Misappropriation of goods is more difficult to detect, unless accurate stock records are kept, in fact, unless such records are in use, it is almost impossible to discover small misappropriations of this nature That losses of stock are taking place may be indicated by fluctuations in the

percentage of gross profit to sales, but this will not locate the fraud itself. The falsification of accounts, unaccompanied by actual misappropriation, is usually far more difficult to discover, as this is generally perpetrated by directors or managers who wish to bolster up the concern by showing fictitious profits in order to pay dividends, to obtain further credit, to increase commissions due to themselves, or with a view to the disposal of their holdings in the company at high prices. In such cases, as the fraud is committed by responsible and trusted officers of the company, an auditor must be particularly vigilant if he is to discover it, as probably he will be given intentionally false information and explanations. He can, therefore, discover such frauds only by the exercise of considerable care and skill, and by making exhaustive inquiries and research.

Routine Checking

It must be observed that the mere routine checking of an audit as a rule will disclose only clerical errors and very simple frauds, and will seldom, if ever, reveal errors of principle or clever frauds. In order to discover these, the auditor must go behind the actual books of account and examine original records, and make intelligent inquiries, in fact, he must go to the foundations upon which the books have been built up. In the following chapters an endeavour is made to show the lines upon which an auditor must work in order to discharge his duties, but at the outset it cannot be too strongly emphasized that an auditor must avoid becoming submerged in the detail and routine work of an audit. He must be constantly vigilant, he must not take things for granted, but must in all cases satisfy himself on every point by making proper inquiries. He must work upon a definite and intelligent plan, constantly bearing in mind the weak spots in the system of book-keeping in respect of which errors or fraud are most likely to occur. Although it is impossible to discover a clever fraud or important errors of principle if the audit consists purely of what may be called "tick work," this routine checking is of importance, but if the audit is backed up by nothing else, probably only clerical errors will be discovered.

The routine checking in an audit is apt to become very monotonous and, consequently, somniferous, but it is most essential that it should be done thoroughly and intelligently This part of the work often devolves upon the junior members of the auditor's staff, and they should endeavour to think out exactly what part the checking that they are engaged upon plays in the whole plan of the audit, what are the likely errors or frauds that might take place, and how these latter would be detected by the checking In this way the work will become far more interesting, and if the junior has any natural aptitude, he will soon commence to gain a grasp of the principles of practical auditing, an acquisition which is bound to advance him in his profession, and one, moreover, which will make his work more and more absorbing, in a way probably that at the commencement would have been thought impossible

Extent of Auditor's Investigations

It is not sufficient for an auditor merely to compare the Balance Sheet and Profit and Loss Account with the books of account, but he must go, to a certain extent, behind the books Errors of principle and fraud, as a rule, will not be discovered upon the surface, but will be detected only by investigations outside the actual books that form part of the system of double entry The auditor, therefore, must use every reasonable care and precaution in order to satisfy himself that the books themselves are correct, and include all the transactions that should be recorded therein Therefore, the extent to which an auditor must carry his investigations is a practical question of great importance, and of necessity it must depend largely upon the whole of the circumstances of each case In a small business, where there is no proper internal check, a prudent auditor will check and vouch a far greater proportion of the detail transactions than he would in the case of a larger business where an efficient internal check was in force Where, for instance, there is a head book-keeper who has control of all the books and who is assisted by a few juniors, the head book-keeper, having access to the whole of the books, can make adjusting entries, and has every opportunity to cover up a fraud If, then, he is skilful, it will be almost impossible

to detect such fraud by mere routine checking of the books Audits of this type present a problem of no little difficulty to the practitioner

Internal Checks and the Auditor's Position in Regard Thereto

In a large business, where there is a staff of some numbers engaged upon the books, it is quite a simple matter to organize a system of internal check that may relieve the auditor of a considerable amount of detail checking, and thus limit his investigations behind the books themselves to occasional tests An internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently checked by other members of the staff For example, the clerks in charge of the ledgers should not keep, or be allowed to make entries in, the books of first entry, on no account should the cashier be allowed to have any control over the ledgers A system of self-balancing ledgers may be made to form a very valuable part of the internal check, as also may automatic tills for checking cash receipts, and time-recording clocks for checking wages Large undertakings commonly have an internal audit department, which carries out a continuous audit throughout the year This internal audit is complementary to the professional audit The auditor should examine the internal audit programme and reports in order to see what ground has been covered, what points have arisen, how they have been dealt with, and generally to satisfy himself that the internal audit has been thorough and efficient Where there is an efficient system of internal check, it is difficult for any extensive fraud to take place except as the result of collusion between various members of the staff Internal checks do not make fraud impossible by any means, but they make it more difficult and the chance of detection much greater, and, therefore, act as a valuable moral check The auditor should investigate the whole system, and when checking the books pay special attention to any weak points, he should also satisfy himself that the internal checks are carried out, and he should test this by checking here and there, haphazard If the system is an efficient one, an auditor

may rely thereon to a considerable extent as regards a large part of the detail work, and thus will have more time to devote his attention to the more important parts of the audit

The extent to which an auditor may rely safely upon internal checks, and omit to check the whole of the detail entries, depends entirely upon the whole of the circumstances of the particular case, and this question must be decided by each auditor for himself In this direction he requires considerable skill, experience, and judgment, and the efficiency of his audit will depend largely upon the skill with which he deals with this question

Commencement of New Audit

Before commencing a new audit, an auditor should ascertain, by reference to statute, or from the instructions received from those employing him, precisely the scope of his duties He should next acquaint himself with the exact nature of the particular business, and make himself familiar with the technical details of the various transactions If, for example, he is to audit the accounts of a factory, if it be possible he should ask to be shown over the factory, as in this way he will see and appreciate what is the nature of the transactions that are recorded in the books, and he will understand roughly the process, and the nature of the machinery, materials, and labour involved This knowledge will enable him to exercise a much more complete grasp of affairs, and he will appreciate the essentials much more readily than would be the case if he saw no further than the counting-house

The next step should be to obtain a list of all the books of account, and the names of the principal officials, after which he should thoroughly investigate the whole system of book-keeping and the internal checks, if any, in vogue In any large business, the detail involved will be enormous, and the auditor must, therefore, consider carefully the whole system, in order that he may decide what ground his investigations must cover, and how far, and in what directions, he can rely upon the internal checks His endeavour should be to see that the system is such that every transaction does become properly recorded in the financial books,

that there is no possibility of items being omitted or altered purposely or accidentally, and that no fraudulent entries can be made The auditor should also study any legal documents governing the concern, such as the Articles of Partnership in the case of a partnership, the Memorandum and Articles of Association in the case of a company, any contracts with vendors and others, special Acts in the case of Parliamentary companies, the will or settlement in the case of a trust He should make notes of the clauses that are likely to affect the accounts, and with the terms of which he must be familiar during the course of the audit Except in the case of a new business, the auditor should examine the accounts for the previous year and the auditors' report thereon

Audit Programme

If the audit is to be an annual one, during the course of the first year the auditor should prepare, or supervise the preparation of, an audit programme, in which should be recorded the exact details of the work to be performed by the auditor and his staff, columns being provided in order that the persons performing each part of the checking may initial as and when they complete it Thus, it will be seen that in this way the principal, or his responsible clerk, maps out the exact scheme of the audit in the first place, after carefully considering the whole of the circumstances of the case He may then be certain that the audit staff will cover the whole of the necessary ground, and if, in future years, different members of the staff are engaged upon the audit, they can see by reference to the programme exactly what work they are required to perform, and further, the principal can see at any time what part of the work has been completed, and what remains to be done In a large practice, unless some such method is adopted, the principals must of necessity lose a very large amount of control, and will be very much in the hands of their staff, and, in fact, the efficiency of the audit will depend, not upon the skill and competency of the principals, but upon the skill and competency of the member of the staff in charge of the particular audit

There is one objection to this mode of procedure, and that is, that the clerks in charge may lose a sense of

responsibility, and carry out the work in an automatic manner It should be impressed upon them, therefore, that the programme set out is the basis upon which the audit is to be conducted, and that they must use their intelligence when carrying it out, and they should be encouraged to make surprise checks outside the audit programme and to recommend additions and improvements in the scheme, for it is most important, as time goes on, that the scheme should be kept constantly up to date, as otherwise serious flaws may develop For this reason, it is important that the principals should reconsider the programme from time to time Practical experience shows that serious discrepancies in accounts are generally revealed by surprise investigations and inquiries, this fact, therefore, should be constantly borne in mind The greatest danger in practical auditing is that the work may become mechanical

Notes During Audit

The question as to what notes an auditor should make during the course of an audit, is one upon which there is some difference of opinion All unimportant queries and mistakes should be settled and adjusted as they occur, and it is not necessary to make notes thereof, but notes should be made of all important questions that arise, and of all important oral instructions and information given by the management Notes should be made of all missing vouchers, invoices, etc, all queries that have not been settled and adjusted, and all matters that have to be remembered from one visit to another Again, all working papers should be filed and kept, as also should the drafts of accounts, and the schedules appertaining thereto In this way, should questions arise in the future, the auditor would be in a position to show exactly what work he performed, what queries he raised, what explanations and information he received, and by whom these latter were given The importance of this will be appreciated later, when the question of an auditor's liabilities is considered It must be remembered that, should anything go wrong, it may be years after the work was actually performed, when perhaps those who were actually in charge are no longer available, so that, if proper records were not kept, the

auditor might find himself in a position of some considerable difficulty

Method of Work Ticks, Calling Back

As regards the actual methods to be adopted when conducting the work of an audit, the common practice is for accountants to adopt special and distinctive ticks for the different classes of transactions that are checked, such as special ticks for castings, cross castings, carry forwards, postings, vouchers, pass book, contras These ticks should be as distinctive as possible, and a rule should be made that similar ticks are not to be used by the staff of the concern whose accounts are under audit Naturally, the meaning of the various ticks should not be explained to clients or their clerks On no account should junior audit clerks allow themselves to be drawn into discussing their work with the employees of the firm whose accounts they are auditing, as the object may be to ascertain whether there are any weak points in the scheme of the audit, which may be taken advantage of for the purpose of concealing frauds Many auditors use different coloured inks for the different periods, as in this way the entries of each period stand out clearly

When calling back, audit clerks should be most careful to speak clearly, as otherwise mistakes may easily be passed For example, £70 6s 3d may be posted £76 3s, and, in order to avoid this mistake when calling back, the "ty" should be emphasized thus, "Seven*ty*-six-three," or this amount should be called back as, "Seventy *pounds* six-three" All bad figures and alterations should be carefully examined, and it should be seen that the same figure is taken in both casting and posting. On no account should erasures with a knife be allowed, and an invariable rule to this effect should be made Some auditors adopt a special tick in the case of altered items, so that it may be seen afterwards whether alterations were made before or after the items were ticked Another good plan is for the auditor to write the correct figure in at the side of any altered and indistinct figure, as this often saves mistakes

Whenever possible, an auditor should refuse to commence checking the books until they have been completely written

up for the period, and on no account should he check figures that are entered in pencil Each stage of the work should be completed at one sitting, if possible, for example, if checking the Cash Book vouchers for a month, the whole should be checked off, and notes made of all missing vouchers—otherwise, if the work is left incomplete, and the books are in the hands of the clients' staff in the meantime, a most dangerous loophole is provided Each part of the work should, therefore, be completely checked, records being kept of the exact points to which the checking has been carried, unless the books are in the entire control of the auditor during the whole time of his audit The risk of the books being tampered with during the audit should always be borne in mind, and preventive precautions taken

After the postings of any book have been checked, the same should be scanned for unticked items, and these should be carefully investigated

The checking of additions is a very mechanical task, but it is important that this should be carefully and accurately done It is extremely easy to pass mistakes when checking additions, unless care is taken, and a good plan is to cover the total when casting up the column until after the total has been arrived at In this way it is difficult for errors to be missed

Continuous and Periodical Audits

Audits may be continuous or periodical A continuous audit is one where the auditor attends at regular intervals during the period of the accounts, say monthly or quarterly, checking the books to date as far as possible A periodical audit is one where the auditor does not attend until the end of the period of the accounts, when the whole of the checking is effected at one time.

The advantages of a continuous audit are that mistakes are discovered soon after they have been committed, when they can be rectified easily, the whole of the circumstances being in mind The opportunities for frauds are lessened when the auditor attends at short intervals, and his frequent attendances act as a valuable moral check, and keep the book-keepers up-to-date with their work Again, should fraud take place, it should be discovered before it

has attained large proportions. As the auditor is not pressed for time, he can carry out a much more detailed audit than is possible when the whole of the work has to be accomplished at one time. At the end of the period, as the greater part of the detail checking will have been completed, the auditor will be able to finish the audit soon after the accounts are prepared. By means of a continuous audit, the auditor is kept in constant touch with the business, thus obtaining a knowledge of what is going on, and, therefore, he is less likely to overlook important points than is the case if he attends, say, only once a year. As the work is spread evenly over the year, it will probably suit the auditor's own arrangements far better than if he has the whole of the work to perform at one time.

The chief disadvantage is that items may be altered after the auditor has checked them, and this danger should be recognized and special precautions taken, as suggested previously, such as special ticks for altered items, and the checking completely through of each part of the work. This danger is not entirely eliminated in the case of a periodical audit taking some days to complete, as the book-keepers generally have access to the books during the absences of the auditor, when it is quite possible that alterations might be made. These dangers can be avoided only by the auditor adopting systematic methods, and being constantly vigilant.

Difference Between the Position of Auditors Appointed under Statute and by Private Individuals or Firms—Partial Audits

The difference between the position of an auditor whose appointment is under statute and that of one appointed by a private individual or firm should be noted carefully. For example, an auditor appointed under the Companies Act, 1929, is acting as the agent of the shareholders to audit the accounts of the directors, who are merely the servants of the shareholders. His powers and duties are defined by statute, and it is his duty to carry out those duties completely. He must act absolutely independently of the directors, although that does not mean that he must adopt an attitude of mistrust or suspicion—in fact, he should do

nothing to engender a hostile attitude, but, should serious questions of principle arise, he must be absolutely fearless, and, having made up his mind as to what is his duty in the circumstances, he must do it, regardless of any pressure the directors may bring to bear. The auditor's powers and duties are defined by statute, and cannot be taken away, nor in any way limited, by either the directors or the shareholders. Some students seem to think that this position does not apply to a private company, where often the directors are the main shareholders. The powers and duties of auditors, as defined by the Companies Act, 1929, apply to auditors of both public and private companies in exactly the same way.

On the other hand, an auditor appointed by a private firm is not appointed under any statute—he is merely acting for the partners, and he must carry out such instructions as he may receive from them. The great importance of this arises where he is not instructed to carry out a complete audit, but merely to carry out a partial audit, and then (as is often the case) to prepare the accounts of the firm. Sometimes an accountant is requested to prepare the accounts, but is not instructed to conduct any audit of the books at all. In such circumstances, therefore, he has no power, nor has he any right, to insist upon carrying out a full audit, and his duty is to carry out faithfully and to the letter the exact instructions he has received—in other words, what he has contracted to do, for the partners may limit the scope of his work in any way that they may please. But, when an accountant receives instructions to carry out a partial audit, or to prepare accounts only, invariably he should see that his instructions are recorded in writing. If he arranges matters verbally with his clients, at the interview he should ascertain exactly what it is that they require him to do, and he should explain to them that he can accept no responsibility outside the work covered by his instructions. Thereafter, and before commencing the actual work, he should write a letter to his clients, exactly setting out the terms of the arrangements made, emphasizing any limitations, so that if questions arise in after years, he may be in a position to show exactly what were the terms of the contract, and, therefore, for what he

was and for what he was not responsible In order to save expense, clients often arrange for a partial audit, but they do not appreciate that the auditor's liabilities are reduced accordingly If, therefore, anything goes wrong for instance, if an employee has been defrauding them they commonly blame the accountant and seek to hold him responsible Now, in such circumstances, it will depend entirely upon what the accountant contracted to do as to whether or not he is responsible The question will be this Having regard to the work he contracted to do, should he have discovered the fraud?

If the original contract is not in writing, the accountant will be in a very difficult position indeed, for in all probability his clients will say that the understanding was that he should cover the particular ground, whereas, he rightly may say that he never received instructions to do that part of the work, and thus it will be a case of one word against the other But if, as suggested, the original arrangement had been in writing, no such difficulty could have arisen, as the exact scope of the work undertaken could be ascertained at once by reference to the correspondence

In the case of *Apfel* v *Annan Dexter & Co*, the trustee in bankruptcy brought an action against Messrs Annan Dexter & Co claiming £28,600 damages in respect of negligence The bankrupt had been robbed by her two sons, who were the managers of her business The plaintiff claimed that Messrs Annan Dexter & Co had acted as auditors and that they should have discovered the fraud, but the defendants contended that they had been employed merely to prepare accounts for submission to the Income Tax authorities and that they had not been instructed to audit the accounts Their certificates upon the Balance Sheets were "Prepared from the books of Mrs Adele Apfel and in accordance therewith"—and it was contended that this certificate made it clear that they had not audited the accounts. His Lordship found for the defendants and held that they had not acted as auditors This case is of great interest to accountants and emphasizes the importance of arriving at a clear understanding with the client in all cases where a full audit is not carried out

The same point is illustrated in the case of the *Maritime Insurance Co Ltd* v *William Fortune & Son*, one of the main questions being as to what was the exact scope of the auditors' employment In his judgment His Lordship stated that "the case was made the more difficult because of the fact that the employment of the defendants, upon which a great deal turned, started more than thirty years ago " The company had sustained a loss by reason of the defalcations of a trusted employee, who covered up the fraud "by omitting to enter in the books of account the receipts of considerable sums in cash and cheques " The question at issue was whether the auditors should have discovered the fraud

In his judgment His Lordship expressed the opinion that the auditors were not engaged to carry out a full audit, and that they had properly carried out the work which they contracted to do

In his view there was nothing which excited or ought to have excited their suspicion They were not in possession of material which would have enabled them to know whether the business of the branch was being satisfactorily conducted or whether the books of account truly showed the state of affairs of the branch He thought that the reason why the misappropriation of money was not detected before was because there was no system in vogue by which the cash received could be checked The acts and omissions which brought about the trouble were not the acts and omissions of Messrs Fortune & Son, and they had been guilty of no breach of duty or negligence

The case of *Leech* v *Stokes* and others also raises this same point. A claim was made against a firm of chartered accountants for £3750 for damages for negligence and breach of duty The circumstances were that the cashier of a firm of solicitors misappropriated rents which were collected for clients by the firm of solicitors The accountants had been instructed to prepare annual Profit and Loss Accounts for the firm for submission to the taxation authorities No proper books of account were kept, there being no Cash Book nor a Clients Ledger and, therefore, no Balance Sheets were prepared All that was available was a Costs Furnished Book in which appeared the costs rendered to clients and weekly summaries of the firm's expenses From these particulars the Accountants prepared the Profit and Loss Accounts They did not verify the

transactions or carry out anything in the nature of an audit The plaintiff claimed that, as the auditors, they should have verified the records before preparing the Profit and Loss Accounts, that they should have prepared a Balance Sheet, and that had they done so the defalcations would have been revealed The defence was "that the defendants were instructed merely to prepare a return of profits of the firm for income tax purposes and that no investigation of the books was necessary or required for that purpose" The accountants' clerk who carried out the work stated that he understood his instructions to be "that he was simply to extract the figures from the books" The accountants certified the first year's Profit and Loss Account as follows

> "We have prepared the above account from the books of the firm and, subject to our report of this date, we certify that it is correctly drawn up in accordance therewith"

In his judgment His Lordship stated "To my mind the incorporation of the report of the 18th May in this case is the really valuable part of this first certificate, for it was in these terms—

Dear Sir,

We have pleasure in enclosing Profit and Loss Account for the year ended 5th April, 1928 Costs and Agency Fees This total has been compiled from the Costs Furnished Book, which, we are informed, includes all costs and fees furnished during the year In accordance with your instructions we have excluded the sum of £655 1s 7d as representing costs, etc , earned prior to 5th April 1927, the date of the commencement of the present partnership Office Outlay The total expenditure during the year, as shown by the weekly summaries, amounted to £1235 18s 5d , of which the sum of £450 4s 2d represented sundry disbursements charged to clients These latter have been deducted from the costs and agency fees as shown in your statements, leaving office expenditure amounting to £875 14s 3d If you approve of the account we shall be pleased to forward a copy to the Inspector of Taxes on hearing from you We are returning your statement herewith

His Lordship stated

"That report states clearly that the account is merely a mechanical compilation of the figures from the Costs Furnished Book, and it refers to the information given verbally to the auditors and not contained in the book

With the Profit and Loss Account this report was sent to the Inspector of Taxes attached to the client's declaration on the yellow form, which was a very proper thing to do "

The embezzlements were all of clients' moneys and therefore did not affect the Profit and Loss Accounts His Lordship stated "All the accounts prepared and sent in to the Inspector of Taxes were correct in fact," and further "I am satisfied that a Balance Sheet could not have been prepared in the absence of a Clients Ledger and Cash Book and that if a Balance Sheet had been necessary, apart from being a reasonable and desirable requirement, which might or might not have been dispensed with, they would have required to write up the Cash Book and have all the entries posted to it and the entries made from the Cash Book to the bank account written up and reconciled The auditor would require also to prepare a Clients Ledger and write it up as his first record and possibly have the Ledger balances verified by the clients' signature " The Accountants advised their clients that proper books ought to be kept and a Balance Sheet prepared, and further they provided a set of books in which they made the opening entries, but when they next attended the Clients Ledger had not been written up on the grounds that the cashier was over-worked His Lordship found that "the instructions given to the defendant firm were to prepare a report of profits for the Inspector of Taxes," but although a Balance Sheet was desirable that "in this case there was no proper book-keeping material available for the preparation of a Balance Sheet," and therefore that "the auditors were not negligent in accepting the assurances of the active partner that the Costs Furnished Book and the weekly cash summaries contained the correct records of income and expenditure," and therefore that the accountants were justified in preparing a Profit and Loss Account from the material available, and that there was "nothing to reasonably arouse the suspicion of the auditors," and "that there was no actionable negligence or breach of duty on the part of the defendants in any of the matters relied upon "

An Appeal lodged by the plaintiff was decided in favour of the defendants and is reported and dealt with in a leading article in *The Accountant* of the 10th July, 1937

Upon this point also the case of *The Scarborough Harbour Commissioners* v *Robinson, Coulson, Kirkby & Co*, which is dealt with in Chapter XI, is of great interest

A wise precaution is to make it a practice, in the case of partnerships, to write a report with every Balance Sheet, in which attention is drawn to any points of importance, and also to the fact that the Balance Sheet has not been, or has been only partly, audited, and at the foot of the Balance Sheet a reference is made to this report, such as "The foregoing Balance Sheet is to be read in conjunction with our report of such and such a date" There is much to recommend this procedure, as accounts are constantly being produced to third parties for various purposes, such as obtaining credit, loans or advances Accounts are often furnished in this way to intending partners or purchasers of the business and to others who have entered or propose to enter into business relations with the firm Such persons may be seriously misled by the production of accounts, bearing a professional accountant's name, which they may be informed have been audited by him, whereas, in fact, this may not be the case If the above course were adopted invariably, the accountant's position would be absolutely secure in the case of difficulties arising with his principals or with third parties who have acted upon the accounts without reference to his qualifying report

Qualifications of Auditor

The qualifications required by an auditor are many and varied First of all, he must have an absolutely complete and thorough knowledge of book-keeping and accountancy, as an auditor in course of time is called upon to deal with many different systems of book-keeping in many different businesses, and unless he understands exactly how such accounts should be prepared, he cannot check them, therefore, he must be complete master of his subject, and thus be able to apply his knowledge to any set of circumstances He must thoroughly understand practical business, and be able to grasp the technical details and the business methods of any concern whose accounts he is called upon to audit A knowledge of accountancy is essential, but

that alone will not make a competent auditor, for the science of auditing is quite apart and distinct from accountancy Many beginners seem to think that, provided they are able to follow the system of book-keeping and that the Trial Balance agrees, everything must be in order, and the auditor has only to check the preparation of the Profit and Loss Account and Balance Sheet, and to sign his report The agreement of the Trial Balance proves nothing, except the arithmetical accuracy of the books An auditor requires a considerable legal knowledge, and must be complete master of the principles of auditing in all its bearings In addition to his scientific knowledge, he must be above all things a man of affairs, and possess tact and character, he must not be easily led and influenced by others, but knowing what his duty is, he must be able to do it in spite of direct or indirect pressure He may find himself in positions when his duty to his client is opposed to his own interests, and in such circumstances he must have the courage to carry out his duty faithfully, regardless of the effects it may have upon himself In the long run, the reputation he will thus gain for absolute integrity will prove of far greater value to him than any temporary loss in the first case An auditor must be methodical and painstaking, and he must be endowed with considerable perseverance, for much of the work is of a somewhat mechanical nature, but it is essential that the whole should be thoroughly and carefully done He must never pass any item unless he understands its nature and is absolutely satisfied that it is in order, if he is not, he must make intelligent and exhaustive inquiries until he has ascertained the exact state of affairs One of the greatest dangers is to pass entries which are not completely understood, because the auditor is fearful of displaying ignorance by asking questions If he cannot ascertain for himself, he should, without fail, ask for the necessary information, for should he affect to possess knowledge which, in fact, he does not, he inevitably will make mistakes that will be far more damaging to his reputation than would be the case if he asked for information upon, for instance, technical details of which he has not had previous experience An auditor must be practical, and if asked for professional advice, must appreciate the practical

requirements and circumstances of the business, and thus avoid making recommendations which, though perhaps theoretically perfect, are entirely unfitted to the circumstances of the particular business. But it must be noted that it is no part of an auditor's duty to give advice unless it is asked for, though in practice his advice is generally much appreciated if it is given tactfully; however, he cannot insist upon his recommendations being carried out. But if, for example, the system of book-keeping be so deficient that it is impossible to prepare accurate accounts, then he would be bound to report upon the unsatisfactory state of affairs.

In this chapter the general principles upon which an audit should be based have been set out at some length; in the subsequent chapters it is proposed to describe the detail work of an audit, and the various questions and difficulties that constantly arise in practice.

CHAPTER II

ROUTINE CHECKING AND VOUCHING

Checking Castings and Postings

THE checking of castings and postings forms part of an audit, and though this work is somewhat mechanical, it is very important that it should be carefully and intelligently carried out The extent to which the auditor will take his checking in this direction depends upon the system of book-keeping and internal checks in vogue In the case of small businesses, where there is practically no internal check, the whole of the castings and postings may have to be checked —in these cases, too, the auditor is often instructed to balance the books, and, consequently, it will be found necessary in all probability to do this checking for this purpose The balancing of the books and the preparation of the accounts are not part of an auditor's duties, though in practice he often is requested to carry out this work in the case of small concerns, and it must be remembered that, if he does so, he is acting as accountant and not as auditor In the case of a large business, where there is an efficient internal check, and the books are balanced by the staff of the concern, it is not necessary or usual to check the whole of the castings and postings These are tested by checking a proportion only, but some judgment is necessary in deciding what to do and what not to do, the circumstances of the particular case being all-important, and it is impossible to lay down any hard and fast rules However, assuming a proper internal check and that the books have been balanced, the following is an outline of the routine checking that would be carried out by a cautious auditor

CASH BOOK The castings and postings should be thoroughly checked, but if self-balancing Sales and Bought Ledgers are in use, the Cash Book being provided with analysis columns for this purpose, it may be sufficient if the totals of the Sales and Bought Ledger cash are checked into the total accounts, and a proportion only of the detail postings checked to the Personal Ledgers But, as a rule,

the whole or the greater part of the General Ledger postings should be checked, in order that the auditor may ascertain that all these items have been posted to the correct accounts The checking of these latter items should never be done mechanically, but the nature of each should be observed, especial care being exercised with all amounts debited to capital accounts, no such entries being passed until the auditor is satisfied that they are in order, and are properly dealt with in the books

SALES AND BOUGHT DAY BOOKS The auditor should check the totals to the Impersonal Ledger and to the total accounts, if kept, and a proportion of the detail castings and postings

RETURNS AND ALLOWANCES BOOKS The totals should be checked to the Impersonal Ledger and to the total accounts, and a proportion of the detail castings and postings should be checked, the larger items being scrutinized

PETTY CASH BOOK The castings and postings should be thoroughly tested, both the postings from the Cash Book to the Petty Cash Book, and those from the Petty Cash Book to the Impersonal and Personal Ledgers

POSTAGE BOOK If there is a proper internal check, it will be sufficient if occasionally the amounts drawn from petty cash are checked into the Postage Book, and the castings and balances of this latter book checked It is very common to find small defalcations in connexion with postages, and, therefore, this book should not be lost sight of, but should be called for at odd times, and a portion carefully checked

JOURNAL All the castings and postings should be checked, no item being passed until the auditor is satisfied that the same is correct in every particular

TRANSFER JOURNAL The totals should be checked to the total accounts (if any) and a proportion of the castings and postings should be checked

WAGES AND SALARIES BOOKS AND STOCK SHEETS The castings of these should be thoroughly checked, unless the auditor is satisfied that they have been checked completely and independently by the staff of the particular concern, as it must be remembered that there is no double entry check upon these totals.

BILLS RECEIVABLE AND PAYABLE BOOKS The detail here will not be very great, so that the whole of the castings and postings can be checked—the totals being checked to the total accounts if the ledgers are kept upon the self-balancing system

SALES AND BOUGHT LEDGERS A proportion of the castings of the above should be checked, and all the balances should be checked on to the schedules of balances as at the date of the accounts, and if the ledgers are self-balancing, it should be seen that the totals of the various lists of balances agree with the balances upon the respective total accounts

IMPERSONAL OR GENERAL AND PRIVATE LEDGERS The castings should be thoroughly tested and the whole of the balances of these ledgers should be checked If the books have not been balanced, then at the same time each account should be carefully scanned for unticked items, which should be most carefully investigated, and on no account ticked as having been passed accidentally by one of the audit staff, unless the auditor is absolutely certain that such is the case In any event, notes should be made of any such unticked items, as it may be discovered, upon further investigating these entries, that they account for the difference on the books

The foregoing checking is based upon the assumption that there is an efficient internal check, and that the Cash Book, Personal Ledgers, General Ledgers, and books of first entry are all under separate and independent control If this is not the case, the checking will have to be carried further, and in this connexion the auditor must exercise his judgment and experience, but it is a wise policy to err on the side of over-checking rather than under-checking An auditor should not endeavour to do as little checking as possible, but rather to do as much as he can

However, it must be emphasized that this routine checking is unlikely to reveal serious discrepancies or fraud, and there is a real danger of far too great a proportion of the time engaged upon an audit being devoted to this part of the work, whereas such time would be more profitably employed in other directions For example, to check the whole of the Sales Ledger postings in a large business will involve a considerable amount of time, but

probably only clerical errors will be revealed This checking, however, will in no way prove that the whole of the sales of the business have been included or that all the sales are genuine

Differences in the Balancing of Books and the Detection Thereof

It sometimes occurs that the staff of a business is unable to balance the books, and the question arises whether an auditor in any circumstances can pass accounts in which there is an undiscovered difference In the case of a small business, where the detail involved is not great, a difference should be discovered, but in a case where the detail involved is very heavy, a small difference may be passed, provided that the auditor is satisfied that the books have been so thoroughly checked that it is practically impossible that the discrepancy represents the combined effect of several mistakes There is considerable danger in passing a difference in the agreement of a set of books, even though it is small, for unless the books have been checked exhaustively and properly, there may be errors involving large amounts on both sides, the difference between which gives rise to the discrepancy, and these errors may affect the accounts considerably, or might even represent frauds If the ledgers are kept upon self-balancing principles, no difference should ever be allowed to remain undiscovered upon the Impersonal and Private Ledgers, but only upon the Sales and Bought Ledgers, and even in the latter cases, this should be permitted only when, owing to pressure of work, the staff cannot afford the time to look for the difference, such difference being small in amount, and the books having been checked already extensively Where there is an adequate staff, there should be a rule that all ledgers must be agreed, otherwise the ledger clerks are apt to become careless and slack, further, the ledgers should be agreed at as short intervals as possible, as in this way the magnitude of the task of balancing them is reduced

Accountants are often instructed to balance books, and this is sometimes an arduous and laborious task, in the carrying out of which considerable care and method is necessary, especially in cases where the books have been

badly kept. If the ledgers have been kept upon the self-balancing system, it will be seen at once in which ledgers differences lie, and it will be necessary merely to check the details of these particular ledgers until the errors are discovered. But where this system is not in force the field is much wider, and the task may be far more troublesome. One of the first things to do would be to check the balances of the various ledgers on to the Trial Balance and the schedules of debtors and creditors. Thereafter, the castings of the Trial Balance and the schedules should be checked, when the exact difference will be ascertained. When checking the ledger balances, the castings of the accounts should be checked, as also should the bringing down of the balances. At the same time it should be seen that the totals of the two sides of each account in fact do agree; errors are easily passed if this is not the case. If the whole of the postings have been checked already and ticked, each ledger account should be scanned for unticked items, as also should the books of first entry. All bad and doubtful figures should be re-checked and made clear. It is sometimes possible, from the amount of the difference, to gather some idea as to the probable nature of the same. For example, a difference of 10s., £10, £100, is probably an error in a casting or carry forward. If the difference is divisible by two, it may be an item posted to the wrong side of a ledger account; for instance, a difference of £14 8s. 4d., representing an excess of debits over credits, may be accounted for by an amount of £7 4s. 2d. having been posted to the debit instead of the credit of an account. The books should, therefore, be scanned for items of this amount. Differences are often caused by figures being entered in the wrong columns, such as 5s. 4d. posted as £5 4s., in which case there would arise a difference of £4 18s. 8d., or £170 6s. 3d. posted as £176 3s. It should be calculated whether any such mistake will give the amount of the error, and, if so, any such item should be looked for, and, if found, checked. Any amounts exactly equalling the difference should be checked, as they may represent a single entry, for which there is no corresponding credit or debit, as the case may be. Often in practice, the time spent in trying to find the difference by these "short cuts" is time wasted, and the

only way is to continue checking until the errors are revealed

After the balances have been checked as suggested above, it is sometimes a good plan to check completely the castings and postings of the Impersonal and Private Ledgers, and possibly also the Bought Ledger, in which the detail, it may be, is not great If the error is not discovered, it will be necessary thereafter to turn to the Sales Ledgers It is well to have the castings of the books of first entry checked, but in the case of the Cash Book, if this has been agreed with the Pass Book, it may be unnecessary to check the castings If the difference is still undiscovered, the accountant will have to check the postings of the Sales Ledgers, until the cause of the discrepancy is brought to light Some accountants prefer to call back postings from the ledger to the books of first entry, thus completely checking each ledger account, at the same time checking the castings and the balance on to the schedule of balances When checking balances, it is important to check the opening balances with the schedules of the previous period, as the difference may be accounted for by an error in bringing down the commencing balances

As a last resort, it is sometimes necessary to analyse the ledgers, in order to discover in which ledger the difference arises, and also in what direction it lies This means analysing each ledger account under various headings, upon specially ruled analysis paper For example, in the case of a Sales Ledger, the columns on the debit side would be as follows—

Opening balance,
Goods debited,
Sundry items,
Transfers,
Total,

and the headings on the credit side would be—

Cash credited;
Discounts,
Allowances and Returns,
Bad Debts written off,

Bills Receivable,
Transfers,
Sundry Items,
Closing Balance,
Total

The cross cast of each sheet will prove that arithmetically the analysis is correct, and that the ledgers have been cast correctly The total of the opening balances should agree with the list of the previous period, the total of the goods debited should agree with the total sales as shown by the Sales Day Books—if there is a difference, it must represent errors in posting or casting In the same way, the totals of the allowances, etc., and bad debts can be agreed By analysing the Cash Book, the total cash and discounts credited to the Sales Ledger can be agreed with the totals according to the analysis of the ledger Owing to the time and labour involved, it is doubtful, except in extreme cases, whether it is worth while to analyse the ledgers in this way, and whether, instead of doing so, it is not better at once to commence checking the ledger postings, etc, as, on completion of the analysis, the actual mistake is not discovered, but only the fact that it lies somewhere in a certain ledger, and in a certain book of prime entry, for instance, that it is in the posting of the sales, in which event the postings of the sales will have to be checked until the error is found

Vouching

Vouching is the very essence of auditing, and the whole success of an audit depends upon the intelligence and thoroughness with which this part of the work is done Vouching does not mean merely the inspection of receipts with the Cash Book, but includes the examination of the transactions of a business, together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorized, and are correctly recorded in the books By this means the auditor goes behind the books of account and traces the entries to their source, and it is in this way alone that he can ascertain the full meaning and circumstances of the various transactions, for if he confines

himself to the entries as they appear in the books of account, his information will be incomplete, and he may pass matters of the utmost importance which affect the accounts very materially The entries in the books show only such information as the book-keeper chooses to disclose, and such information may be purposely or unintentionally contrary to the true facts—therefore, only by examining external evidence can an auditor possibly ascertain the real state of affairs An auditor is blindfold who does not base his audit on thorough and efficient vouching In most cases clever frauds can only be discovered by vouching, so that it is essential that this part of an audit should be conducted with great care and intelligence The importance of this is clearly brought out in the case of *Armitage* v *Brewer and Knott*, which is referred to in Chapter XII

When checking vouchers, a special tick, or, better, a rubber stamp, should be impressed upon the document inspected, and this marking of the voucher should be distinctive, as the object is that the same may not be produced again in support of another item It is well to denote, by the place where the voucher is marked, the purpose for which it has been taken, as, for example, an invoice may be produced twice to the auditor, once when vouching the Bought Day Book, and, subsequently, if receipted, when vouching the Cash Book The entry in the books should be ticked in a distinctive way when the corresponding voucher has been accepted

Whilst the original vouchers are before the auditor, he should make careful note of various matters to which attention will have to be paid subsequently, or of any subsidiary information derivable from the documents Such cases will include when further information or authority is required, or when additional documents such as contracts, Articles of Association, or minutes have to be inspected When examining vouchers for rent, rates, taxes, insurance, commissions, salaries, etc, the period covered by the payment should be scrutinized, and notes made of any apportionments and outstandings that will have to be provided for at the end of the period Other information may be noted, such as the purchase prices of important materials, this information being most valuable

for the purpose of verifying the prices at which such materials are taken into stock. By such methods the re-examination of documents is obviated, and time is thereby saved.

CASH BOOK. Before settling his programme for vouching the Cash Book, an auditor should inquire carefully into the whole system of internal check (if any) that is in force with regard thereto. The following suggestions show the lines upon which such inquiries should be made—

(1) Has the cashier control of any of the ledgers or books of first entry? If so, special care should be taken in this direction, since the opportunities for fraud are thereby increased considerably.

(2) Who opens the letters, what records are made, and are all cheques and postal orders immediately crossed to the clients' bankers, and also marked "account payee only"?

(3) Who enters the cheques and moneys received into the paying-in book, and who actually pays into the bank?

(4) Are all receipts banked daily?

(5) Who makes out and sends off the receipts for moneys received?

(6) What control is kept upon unused receipt books? Are they kept under lock and key, and issued only when current books are used up completely?

(7) Is a rough Cash Book kept, and who writes up the Cash Books?

(8) How often, and by whom is the Cash Book checked and agreed with the Pass Book?

(9) What internal checks are there as regards cash sales and miscellaneous income?

(10) Are travellers or agents allowed to collect debts due to the concern? If so, to what internal checks are they subject, and what records and returns do such travellers or agents make?

(11) Who controls the preparation and dispatch of the monthly statements to customers?

(12) How are invoices and accounts received, checked and passed for payment?

(13) Who draws the cheques? Are the cheques which

are drawn in payment of accounts crossed prior to signature "not negotiable" and "account payee only"?

(14) Who controls the dispatching of the cheques and covering letters?

(15) Who checks the receipts for payments with the Cash Book, and how are such receipts filed?

(16) Who posts the entries from the Cash Book to the ledgers?

(17) Are the monthly statements received from creditors independently checked with the Bought Ledger accounts?

Upon the completion of this investigation, the auditor will draw up the scheme of his audit of the Cash Book, paying special attention to any weak points in the system, and all places where, from his experience, he sees that loopholes are likely to be found He should point out to his clients any weaknesses in the system, and, although it is no part of his duties, in practice, as a rule, he would advise them as to the manner in which the system could be improved and strengthened There are two main objects of such a system The first is to ensure that all the receipts of the business from all sources are accounted for, and, therefore, every precaution should be taken, by means of internal checks, to make it as difficult as possible for the receipts to be misappropriated The second is to ensure that no improper or fraudulent payments are made, that every payment has been properly authorized and is a bona fide business expense, that the transaction is properly recorded in the books of account, and that the payee actually has received the amount

BANKER'S PASS BOOK One of the first steps in vouching the Cash Book should be the checking of the same with the Banker's Pass Book The individual items in the Cash Book should be called back with the Pass Book, both the Cash Book and Pass Book entries being ticked, and the reconciliation statement at the end of the period should be checked, thus agreeing the Cash Book and Pass Book balances The cheques, both paid in and drawn, that are not through the Pass Book at the date of the accounts, and which appear in the reconciliation statement, should be traced through into the Pass Book for the succeeding period, in order that it may be seen that such

outstandings are bona fide transactions which do appear in the Pass Book, though in the following period If the audit takes place some time after the close of the financial period, and there are outstandings that are still not through the Pass Book, inquiries should be made as to the reasons When checking the debit side of the Cash Book with the Pass Book, it should be seen that the dates agree—except in the case of country cheques, which will, as a rule, not be credited in the Pass Book for a few days—because many frauds are committed by the simple expedient of delaying the banking of moneys, the defaulting person having the use of such moneys in the meantime, and thus always being in possession of part of the funds of the concern

When checking the credit side of the Cash Book with the Pass Book, it should be seen that the dates and names in both correspond, and that all bank charges, dishonoured cheques, etc , have been entered in the Cash Book In cases where the Pass Book has been checked already and agreed by the staff of the business, and a reconciliation statement is placed before the auditor, some accountants merely check the credit side of the Cash Book in total, though, even in such circumstances, the debit side should be thoroughly checked, all contras being noted, inquired into, and taken into account when agreeing the credit side in total Should the auditor have to prepare the reconciliation statement, he will tick off the Pass Book items with the Cash Book, as indicated above, and thereafter he will scan the Cash Book for unticked items on both sides—these should represent items not yet through the Pass Book From the Pass Book balance should be deducted the total of the cheques drawn, but not yet paid by the bank, and to this amount should be added any cheques paid in but not yet credited in the Pass Book The result thus obtained should give the Cash Book balance In the case of an overdraft, the process will have to be reversed

Frauds have been covered up in the past by producing to the auditor a dummy Pass Book, and, therefore, in order to guard against this, the auditor should obtain direct from the bankers a certificate of the balances according to the books of the bank, as at the close of the financial

period of the concern whose accounts are being audited, and it must be seen that these balances agree with the balances shown by the Pass Books produced When making application to the client's bankers, the auditor should ask for a certificate as to *all* of the client's accounts with the bank and particulars of any bills, securities, etc , held by the bank on behalf of the client There have been cases in which there have been accounts with the bank of which the auditor had no knowledge

VOUCHING DEBIT SIDE

The vouching of the debit side of the Cash Book is the more difficult of the two, as the auditor is not so much concerned with the entries that appear as with the possibility that receipts have been omitted, consequently, he is thrown back upon the internal checks, and indirect evidence

PAYING-IN BOOK If the counterfoils of the Paying-in Books have been initialed by the bank, a proportion of such counterfoils may be checked with the Cash Book, the object of this is to ascertain that the whole of the moneys received has been paid into the bank promptly, and also that cheques have not been split improperly The splitting of cheques may arise in this way A payment by A B & Co of (say) £50 in settlement of their account is misappropriated, and, consequently, does not appear in either the Cash Book or A B. & Co 's account in the Sales Ledger If it is left in this state, after a time attention would be bound to be directed to this unliquidated account, and on application being made to A B. & Co for payment, the fraud would be discovered immediately Therefore, in order to cover up this, a later cheque from another debtor, C D & Co , for £100 is entered in the Cash Book as A B. & Co £50, and C D & Co (on account) £50, and the cheque of £100 is paid into the bank In this way, A B & Co 's account is cleared and the defalcation is transferred to a new account and thus for a certain length of time the accounts may be manipulated A comparison of the counterfoils of the Paying-in Book may reveal this fraud, unless the production of the counterfoils to the bank for initialing when paying in has been omitted, in which latter case, the

counterfoils may have been made to agree with the Cash Book by the cashier In cases where fraud is suspected, the auditor should endeavour to obtain from the bank the original paying-in slips in its possession, and these he should check with the Cash Book

RECEIPT BOOKS The counterfoils of Receipt Books may be tested with the Cash Book, though if this check is anticipated, the defaulting party may make them agree with the Cash Book It must be seen that precautions are taken to prevent blank receipt forms being obtained In the same way travellers' receipt books and collecting books should be tested with the cash accounted for by them according to the Cash Book If items which do not appear in the Cash Book are discovered in the Receipt Books, these should be carefully investigated, as it may well be that they represent misappropriations of cash receipts

CASH RECEIVED FROM DEBTORS The best check upon the cash received from debtors is to arrange that those who collect and handle the cash can in no way control the preparation or sending out of the monthly statements, if, for example, statements are sent monthly in respect of every open account on the ledgers, any misappropriation of cash received is almost certain to be discovered, as the debtor, on receipt of the statement, will as a rule at once draw attention to the fact that credit has not been given for the payment he has made

CASH SALES In the case of Cash Sales, an auditor is largely dependent upon the system in vogue If automatic tills are used, the till records should be tested with the cash accounted for under this head In large shops the salesmen should not be allowed on any account to receive the cash, but should make out a bill, carbon impressions being taken automatically, and upon this bill the customer should pay to a desk cashier, who should record such takings in a Desk Cash Book When such a system is in use, the counting-house staff should prepare daily summaries of the cash sales from the Salesmen's Desk Books, and these totals should be checked and agreed with the desk cashier's summaries, and with the total of cash sales paid into the bank, and in the same way the auditor should verify a

proportion of the cash sales If there is no system, or if what system there is is bad and faulty, it is impossible for an auditor to vouch satisfactorily the cash sales, and in such circumstances he should point this out to his principals in writing, and disclaim all responsibility in this connexion until an efficient system is put into force

MISCELLANEOUS RECEIPTS Miscellaneous Receipts are somewhat difficult to check, and the evidence required depends upon the nature of the items The following are examples, together with the methods by which an auditor should vouch them

RENTS RECEIVABLE The leases and agreements with the tenants should be examined, and in this way the exact amounts receivable ascertained The amounts due will then be checked to the rent-roll The rents received according to the Cash Book should be checked to the rent-roll and with agents' accounts, if the rents are collected by agents All empties and arrears should be carefully inquired into, and if the arrears are heavy and fraud is suspected, the auditor should, with the consent of his client, write direct to the tenants requesting them to confirm the amount of the arrears In the case of weekly properties, sometimes each tenant has a rent book in which the collector enters and initials for the amounts received In such cases, the auditor should occasionally call for the production of such books, and see that all the rents entered therein have been accounted for

INTEREST AND DIVIDENDS Interest and dividends received from investments should be checked with the counterparts of the interest and dividend warrants, or the letters covering the cheques In the case of bonds, the bonds themselves should be inspected, and it will be seen by the coupons that have been torn off what interest should have been received If the bonds are in the hands of the client's bankers, the bankers collecting the coupons when due, the entries in the Pass Book will be a sufficient voucher The auditor must see that all the dividends or interest in respect of every investment have been received and accounted for

INTEREST ON DEPOSIT Interest on Deposit will be vouched with the entry in the Pass Book

COMMISSIONS RECEIVED Commissions received will be vouched with the Commission Accounts rendered

AMOUNTS RECEIVED FROM AGENTS Amounts received from agents will be checked with the accounts rendered by the agents, which accounts should have been checked and passed by the management

INTEREST ON LOANS The loan agreement or whatever other evidence there is of the loan should be inspected, it being seen that the interest there provided for has been accounted for

BILLS RECEIVABLE The amounts received should be checked to the Bills Receivable Book, it being seen that all bills due have been accounted for

PROCEEDS OF THE SALE OF INVESTMENTS Proceeds of the sale of investments should be checked with the stockbroker's contract note, which will show the net amount to be received

PROCEEDS OF THE SALE OF SUNDRY ASSETS Proceeds of sale of sundry assets will be checked with whatever evidence is available In the case of a sale by auction, the amount received should be checked with the auctioneers' account and a marked catalogue In other cases, the correspondence, contract of sale, and any other documents in connexion therewith must be examined, in order to ascertain the amount of the sale price

AMOUNTS RECEIVED UNDER AN INSURANCE POLICY Such amounts should be checked by means of the correspondence with, and accounts rendered by, the insurance brokers or the insurance companies

SUBSCRIPTIONS Subscriptions received by a club or society should be checked with counterfoil receipt books, and with the published list of subscribers

VOUCHING CREDIT SIDE

RECEIPTS, ETC The majority of the documents produced in connexion with the vouching of the credit side of the Cash Book will consist of receipts, invoices, and receipted accounts, and when examining these, an auditor should compare the name of the payee with the name in the Cash Book He should note the dates upon the account,

for in this way it may be found that accounts that should have been charged to the Profit and Loss Account of the previous year are being borne by the year under review On the one hand, such a mistake may have been accidental, in which case it should be seen that proper precautions are taken that no such mistakes are made in the future, or, on the other hand, it may be discovered that there has been fraudulent suppression of accounts in the past, and that thus the profits have been inflated. The dates should also be scrutinized, in order to guard against the vouchers of back years being produced in support of fraudulent payments in succeeding years The particulars of goods supplied or services rendered should be scrutinized, with a view to ascertaining that they are proper business charges, and that the private accounts of individuals are not being paid by and charged to the business—therefore, the name of the party to whom accounts are addressed should be examined If private accounts are paid through the business, as sometimes occurs in order that the individual may obtain the benefit of trade terms, it should be seen that the amount is debited to that person's account in the books and that these transactions have been properly authorized

The amount of each voucher should be compared with the amount in the Cash Book, it being seen that any discounts have been properly dealt with in the books The auditor should see that the account has been initialed as having been checked and passed for payment, and that the proper account in the ledger is debited therewith In the case of receipts, if the invoices of the creditor state that only official printed receipts will be recognized, then no other form of receipt should be accepted without full inquiry Receipted invoices should be scrutinized with especial care, as it is very simple for bona fide invoices to be fraudulently receipted by the cashier, for this reason receipts upon creditors' printed receipt forms, and those bearing the creditors' rubber stamp, are far better evidence than an invoice or account merely receipted in ink All receipts[1] for amounts of £2 and over should bear a twopenny stamp, and the auditor should point out any that are not

[1] By the Finance Act 1924 receipts for salaries wages and superannuation and other like allowances were exempted from stamp duty

so stamped, though he cannot refuse to accept such a receipt upon this ground only, if otherwise he is satisfied with the voucher, as all the auditor requires is evidence of payment and that the transaction is in order, and this is not affected by the mere non-stamping of a receipt

Some businesses send with remittances their own form of receipt to be completed and returned by the payees, and there is a growing practice to have a form of receipt printed at the foot or upon the back of the cheque forms In both of these cases such receipts are unsatisfactory ones from an auditor's point of view, as no particulars are given as to the nature of the payment, and they are not good evidence that the payee has received the amount, as there is considerable danger that such receipt forms may be completed fraudulently, and such fraud is extremely difficult to detect Where such receipts are produced, the auditor should insist in the case of all General Ledger items that the corresponding invoices or accounts should be attached, so that he may see the particulars and verify that the payment is in accordance therewith

CONTRA ACCOUNTS Accounts settled by contra account should be traced, the best voucher being a subsequent statement of account which confirms the settlement

PAYMENT OF BOUGHT LEDGER ACCOUNTS In the case of payments in settlement of Bought Ledger accounts, a proportion of the invoices will have been examined when vouching the Bought Day Book, and, therefore, it will not be necessary to call for these again when vouching the Cash Book, the creditors' receipts being sufficient In the case of payments that are debited to General Ledger accounts, however, mere receipts are not sufficient, but the auditor must insist upon the production of invoices and accounts, giving full particulars of the transaction, so that he may see that the same are in order, further, he may have to refer to minutes, contracts, and other similar evidence, before he can pass such payments This part of the vouching of the Cash Book payments requires great care

ENDORSED CHEQUES Notes should be made of all missing vouchers, and in cases where these cannot be found, the auditor should insist upon duplicates being obtained In such cases, the endorsed cheques often are produced to

the auditor, in lieu of a receipt, but these should not be accepted as vouchers, except in special cases An endorsed cheque is not a legal receipt, it affords no evidence as to the nature of the payment, nor is it good evidence that the payee has received the amount, as the endorsement may be forged The only circumstance in which endorsed cheques might be considered sufficient vouchers is when the signature of the payee is well known to the auditor, and there is other evidence as to the nature of the payment, that it is in order, and that it has been duly authorized, examples being directors' fees, salaries, and partners' drawings Even in such cases, however, proper receipts should be obtained, if possible, and it is advisable, with regard to partners' drawings, that the partners should be requested to examine their respective drawing accounts periodically, and, if they find them to be in order, to initial them.

CAPITAL EXPENDITURE Capital expenditure should be most carefully vouched, with a view to ascertaining that the payments are in order, have been properly authorized, and are proper capital charges The question as to what documents will be required depends upon the nature of the payment The following are examples

PLANT, MACHINERY, FURNITURE, FIXTURES, ETC Invoices and receipts will be required, and inquiry should be made in order to ascertain that the items are bona fide capital charges, have been properly authorized, and that no repairs and expenses of maintenance are added to the capital account In the case of a machine, to the invoice price there can properly be added the cost of carriage and the costs of erection

LAND AND BUILDINGS The contract of sale and the solicitor's statement, showing the purchase consideration payable should be seen If the buildings are being erected, the auditor should examine the builders' contract, the builders' receipts, and architects' certificates The title deeds and conveyance or the lease should also be inspected Solicitors' and architects' charges will be vouched by their receipted accounts, and these expenses may be treated as being part of the capital cost

INVESTMENTS If purchased through a stockbroker, the contract note should be inspected, and this will show the

exact amount payable In the case of a new issue, for which application has been made, the allotment letter and banker's receipts for the instalments paid should be inspected, if these have not yet been exchanged for the certificates The share certificates, bonds, etc, will also have to be examined when verifying the assets

PATENTS The patent and, if it has been purchased, the assignment should be inspected The patent agents' receipted accounts should be seen in order to verify the charges to the asset account The receipts for the patent renewal fees should be seen, these fees should be charged to Revenue

LOANS The loan agreement and the security held (if any) should be inspected, and also the authority for the loan, such as the directors' minute In the case of loans to directors and officers of a company, the auditor must see that the terms of Section 128 of the Companies Act, 1929, have been complied with

WAGES The question of wages is one of very great importance in the case of manufacturing businesses, and it is essential that there should be a most complete internal check in this direction The auditor should carefully examine into the system of recording and paying wages, and if it is bad and faulty, he should point out its shortcomings and disclaim responsibility, for in such circumstances it is impossible to prevent, or be certain of detecting, frauds The lines upon which a wages system should be based are as follows

The times of time-workers are best recorded by means of time-recording clocks, and it is important that responsible officials, such as foremen, should see the hands ring in and out upon the clocks, as, otherwise, late arrivals may get their earlier comrades to ring in for them

The times of each employee, as shown by the clock records for the week, should be entered in the Wages Book by one wages clerk, and the rates of pay inserted The amounts should then be calculated, all deductions such as National Insurance contributions, Unemployment, subscriptions, etc, made, and then the Wages Book should be cast The whole of this work should be independently checked, the clerks taking part in each stage of the

preparation and checking of the Wages Book initialing for what they have done

In the case of piece-workers, as the work is given out and taken back by the foreman, particulars should be entered upon piece-work cards or sheets, which should be initialed by the piece-worker and the foreman These cards or sheets should be passed to the wages office, the particulars being entered up in the Wages Book and independently checked as in the case of the time-workers

When complete, the Wages Book should be handed to the cashier, who should have no control over the actual preparation of this book The cashier should proceed to draw and cash a cheque for the exact amount of the week's wages He should then place the exact amount due to each wage-earner in an envelope or can bearing the individual's name or number, after which the Wages Book and the cash thus sorted should be handed to a responsible official, who should pay the workpeople as they leave the works, foremen who know the employees being present to identify them The cashier and the person paying the wages should initial the Wages Book, which should thereafter be returned to the wages office

The above is but a brief sketch of a wages system, but the basis upon which every system should be built up is that the records in the works, the preparation of the Wages Book, its checking, the handling of the cash, and the payment of the wages, should be under entirely separate and independent control The management of the business should watch the wages system carefully, and occasionally either take part in or watch the actual payment of the hands

After investigating the system, and assuming that it is an efficient one, the auditor should check the Wages Book as follows—

Check a proportion of the castings and calculations,

Test the weekly totals of the Wages Book with the cheques drawn as shown by the Cash Book,

See that the Wages Book has been initialed by all taking part in the various stages,

Occasionally test the system by calling for the time records and piece-work cards for a week, and checking these with the entries in the Wages Book

In order to ascertain that no dummy names are included upon the pay roll, the auditor should occasionally call for the production of the National Health and Unemployment Cards for each worker These should be checked with the names in the Wages Book, it being seen at the same time that each card is properly stamped to date

SALARIES A Salaries Book, in which should be entered the weekly or monthly salary of every salaried official, should be kept The book should be ruled with columns in which the actual payments are entered The auditors should test the cheques drawn with the Salaries Book, which latter should be initialed by a partner or responsible official The authority for all alterations in the salaries payable should be confirmed

TRAVELLERS' COMMISSIONS AND EXPENSES Records should be kept for each traveller of the monthly amounts due for commissions and expenses In some cases travellers are allowed a fixed amount for travelling, but where they are allowed to charge their actual expenses, vouchers should be insisted upon for all expenses, except such as railway fares, etc , for which no receipt can be obtained Where this latter method is adopted, the expenses should be carefully watched and checked by the management When the travellers are paid, the amounts should be entered in the travellers' accounts and a receipt should be obtained The auditor should test these records as far as possible, and vouch the cheques drawn, according to the Cash Book, with the travellers' receipts He should also see that all unpaid commissions and expenses are brought into account at the end of the financial period

FREIGHT AND CARRIAGE The payments made should be vouched with the statements rendered by the shippers or carriers together with the receipts The auditor should verify that all shipping and other rebates due have been properly accounted for

CUSTOMS DUTIES If these have been paid by a forwarding agent, the amounts will be included in the agent's monthly statements, to which should be attached the official receipts Receipts are not always given, but they can be obtained if requested The system of payment should be investigated and the payments carefully vouched

PETTY CASH Petty cash should be kept upon the Imprest System, by which the petty cashier is given a round sum which is estimated to be sufficient to cover his expenses for the ensuing week or month, as the case may be At the end of this period, the petty cashier should balance his book and produce it to the cashier, who should check and vouch it, and, if it is in order hand the petty cashier a cheque for the exact amount of the total disbursements for the period The Petty Cash Book should be ruled with analysis columns, in order to save the number of postings to impersonal accounts Vouchers should be insisted upon for all payments above, say, 5s, and in cases where it is impossible to obtain receipts, dockets should be made out, giving details of the expenditure, and such dockets should be initialed by the person actually expending the money The amounts should be entered on the dockets in words as well as figures, so as to guard against subsequent improper alterations of the amounts On no account should anyone, other than the petty cashier, have access to the petty cash, and clerks should not be allowed to borrow from petty cash On the last day of the financial period, all cash balances in hand are sometimes paid into the bank, and on the first day of the ensuing period the petty cashier is given a cheque for the agreed fixed round sum The only sums utilized for petty cash should be the proceeds of the cheques drawn specially for this purpose—all sundry small receipts should be paid into the bank and passed through the Cash Book

The auditor should carefully inquire into the system of petty cash, and report if it is weak or faulty He should test the castings and postings, and the cheques drawn from the Cash Book into the Petty Cash Book He should see that the book has been initialed by the cashier, and he should check at least a proportion of the vouchers, at the same time observing the nature of the payments, and the heads under which they are analysed Occasionally and without notice the auditor should count the cash in hand and agree it with the balance shown by the Petty Cash Book If this is not done at the date of balancing, the book should be checked to the date at which he attends, and the balance then counted and checked with the Petty Cash Book

balance at that date Surprise checks are the only ones likely to reveal a discrepancy, as otherwise the petty cashier will borrow from some source the necessary cash to make up the balance shown by the Petty Cash Book

POSTAGE BOOK The auditor should see that there is an efficient internal check upon the postages, and he should check this book occasionally, checking the amounts drawn from the Petty Cash Book into the Postage Book, and counting the stamps in hand

CHAPTER III

VOUCHING (*continued*)

Bought Day Book

THE whole system as regards ordering and receiving goods, checking invoices, and authorizing payment, should be investigated by the auditor, as, if strict control is not exercised in this direction, the opportunities for fraud are very great The question whether a really effective system can be evolved depends upon the staff available, and if there is no system, or there is a bad one, an auditor should exercise considerable care, and check exhaustively the Bought Day Books and Ledgers

An effective procedure should be instituted as regards the placing of orders For example, if stocks require replenishing, the storekeeper should prepare a requisition note, giving particulars of the materials required, and this requisition should be counter-signed by a duly authorized official It is most important that effective control should be exercised by the management over the placing of orders and that proper records should be kept

All orders should be made out on manifold and numbered order forms provided with carbon leaves, so that every order issued is duplicated automatically

Goods inwards dockets should be kept at the entrance to the works As goods are received, the quantities and weights should be checked, entered on the goods inwards docket, and checked with the delivery notes

The invoices should be checked by the invoice clerk, with the order form and the goods inwards docket, as to particulars, quantities and weights—references to these dockets being placed upon the invoice The prices should be checked with quotations, estimates, or previous invoices After being checked thus, the invoice should be initialed by the head of the department by whom the goods or services were ordered Having been checked, initialed and passed, the particulars of the invoices should be entered in the Bought Day Book, and the invoices numbered and filed

The clerks in charge of the Bought Day Books should

on no account post the entries to the Bought Ledgers, nor should they have anything to do with the drawing of the cheques in payment of accounts

No accounts should be passed for payment until the Ledger has been posted up to date, and a responsible official should authorize the drawing of the cheques, but before doing so he should have been satisfied that the accounts put forward for payment agree with the creditors' accounts in the Bought Ledger

The auditor should test the invoices with the Bought Day Book As he checks each invoice, he should place his audit stamp upon it, so as to prevent the same one being produced a second time Occasionally, especially in cases of suspicion, the order forms and goods inwards dockets should be called for, and the Bought Day Book items tested therewith

When examining an invoice, special attention should be paid to the following points—

(1) That the name of the creditor agrees with the entry in the Bought Day Book

(2) That the invoice is addressed to the auditor's clients

(3) That the date agrees with that in the Bought Day Book, and falls within the period under review

(4) That all trade discounts have been deducted

(5) That the net amount agrees with the Day Book entry

(6) That the invoice has been initialed as having been checked in every way

(7) That the item is analysed to the proper impersonal account

(8) That from the particulars it appears to be a proper business charge

(9) If partners' or directors' and officials' private accounts are passed through the Bought Day Book, that they are charged to their personal accounts

(10) That any invoice charged to capital appears to be a proper capital charge, has been properly authorized, and is debited to the correct account

Profits can be inflated easily by the suppression of invoices (see *Smith* v *Offer and others*, p 220), therefore, at the end of the period the auditor should call for the Goods Inwards

Book and trace into the Bought Day Book all big lines of goods which have come in during the last few weeks The invoice file for the ensuing period also may be inspected, and the dates of the invoices therein examined, to see whether any of these should be charged to the period under audit

In order that the auditor may be satisfied that all invoices have been included, his clients should arrange that at the date of the Balance Sheet a notice should be sent to every creditor who has an account in the Bought Ledger, requesting him to furnish a statement showing the balance due to him at that date, or if there is nothing owing, a notification to that effect These statements and notices should be produced to the auditor, who should compare them with the Bought Ledger accounts, seeing that such statements bear the date on which the financial period ends If all these agree, it is proof that the individual creditors' books agree with the books of the auditor's clients, and, therefore, that, as regards these accounts, at any rate, no invoices have been omitted

A very simple fraud may be perpetrated in connexion with purchases by entering invoices twice in the Bought Day Book, in each case the creditor's account being credited In due course and at different dates, two cheques are drawn, one being sent to the creditor and the other misappropriated Both cheques are debited to the creditor's account, the balance upon which will agree with the creditor's periodical statements In order to provide a receipt in support of the second and fraudulent payment, the bona fide receipt may be produced twice unless the auditor takes the precaution of marking vouchers, in which case the invoice might be receipted fraudulently, or the creditor might be asked for a duplicate receipt on the pretext that the original had been lost Such a fraud cannot be discovered unless the invoices are carefully checked with the Bought Day Book If, however, there is a proper internal check, and the Day Book, Ledger and Cash Book are each under separate control, this fraud cannot be committed unless there be collusion

Bought Day Book : Returns and Allowances

In this book will be entered allowances made by the creditors of the concern whose books are under audit, in respect of goods rejected and returned, damaged goods,

short weight or quantities, errors in calculations, etc The creditor signifies his assent to such allowances by rendering a credit note The auditor should see that there is a proper system for dealing with these items, and, if there is, as a rule he will be satisfied by testing the castings and postings of this book, but, of course, in cases of suspicion and exceptional items, he should compare the entries with documents, such as credit notes, Goods Outwards Books, correspondence, etc

Sales Day Book

The system for dealing with orders received should be investigated, and there should be Order Books in which they are entered upon receipt The actual orders may be in the form of letters, travellers' or agents' returns, or they may be mere oral instructions, but in all cases there should be a permanent record so arranged as to be instantly available for reference

When the order is executed by the dispatch of the goods or the completion of the work, an invoice should be prepared and dispatched immediately The invoices should be duplicated by means of carbon leaves, and from these copies of the actual invoices, the Sales Day Book should be written up By the use of accounting machines the whole of these records, including the writing up of the Sales Day Book, can be effected in one operation of the machine All goods leaving the works should be checked out, and recorded in a Goods Outwards Book

The two main points that an auditor should guard against are the omission of sales and their inflation In the case of a small business, where the head clerk has control over the whole set of books, if he omits to enter sales, it may be possible for him to misappropriate the cash or cheques remitted in payment of such items In these circumstances, no records of these transactions will appear in the books at all, and, consequently, this fraud could be detected only by comparing the Sales Day Book with such original records as the duplicate invoices, Order Books, Goods Outwards Books, etc The inflation of sales will be done with the object of improperly increasing the profits or decreasing the losses, and to guard against this, also, the

Sales Day Book entries should be tested with the original records, in order that the auditor may be satisfied that all the sales entered are bona fide transactions In cases of suspicion, the Sales Day Book should be checked exhaustively, but in the ordinary way, where there is a reliable system of internal check, it will be sufficient to test a proportion of the entries The fact that the auditor calls for the Order Books, duplicate invoices and Goods Outwards Books occasionally, creates a moral check of great value Many auditors elect to spend considerable time checking the Sales Day Book postings, which, it may be, have been checked already and the clerical accuracy proved by the client's staff, whereas the auditor's time would be far better occupied in testing the entries with the original records

When checking the Sales Day Book, the auditor should be careful to see that, if any old assets have been sold and charged out through the Day Book these amounts have not been included in the totals credited to the sales account, but have been credited to the particular asset account, and the profit or loss on the sale properly adjusted for

An excellent check upon the sales, which is sometimes met with in practice, is for a statement to be sent to all debtors of the concern at the date of the Balance Sheet, with a request that they will confirm the fact if the balance agrees with their books, and, if not, point out any differences This method, when properly controlled by the management, proves to be a most valuable check upon the book debts, it acts as a check upon the sales as entered in the Sales Day Books, and is also evidence that the whole of the cash received from debtors has been accounted for in the Cash Book In cases where fraud is suspected, one of the most effective means for detecting discrepancies is for the auditor to control the sending out of such statements and the replies received

Goods on Sale or Return

The auditor should make sure that an effective system is in force for dealing with these transactions and he must see that goods out on sale or return, but unsold at the date of the Balance Sheet, are not treated as sales but as stock,

allowance being made in the valuation for damaged stock and for handling expenses

Packages and Empties

If packages are returnable by customers the auditor should carefully examine the system When packages are charged out to customers they must not be included with Sales but should be kept separate in a special column in the Sales Day Book or in a separate book In the Sales Ledger it is of great assistance if packages are recorded in a separate column At the date of the Balance Sheet a reserve must be made for any profit on the packages in the hands of customers Reserves should also be made for depreciation of packages in the hands of customers and in stock The auditor should test the records with dockets, etc , and he must satisfy himself that the whole of these transactions have been properly handled

Sales Day Book Returns and Allowances

The system as regards these credits to the Sales Ledgers should be inquired into, as it is possible that improper credits may be passed through in this way, in order to cover up misappropriations of cash received from debtors Therefore, all credits should require the authority of a responsible official, and the credit note should be initialed and duplicated by means of carbons The auditor should carefully scrutinize large credits, and, if necessary, examine the documents, such as copy credit notes, correspondence, Goods Inwards Books, etc The credits made after the close of the year should be examined if the amounts are considerable, as sometimes, in order to make the results shown by the Profit and Loss Account more favourable, allowances, etc , are held back until after the date of the Balance Sheet

Bills Receivable Book

In this book will be entered all bills received, and particulars as to when they become due, and how they are disposed of The auditor should see that the proceeds of every bill are accounted for, or, if a bill is dishonoured, the amount thereof plus any expenses are debited to

the particular debtor's account in the Sales Ledger Bills that have been met or discounted will be traced into the Cash Book and Pass Book, and those that are still current at the date of the Balance Sheet should be in hand, and should be inspected by the auditor—in this way, every bill will be accounted for The Bill Book shows the details that make up the balance upon the Bills Receivable Account in the Ledger, and it should be seen that these are in agreement

Bills Payable Book

All bills accepted should be entered in this book, and as they are met they should be marked off therein Those bills that have been paid will appear in the Cash Book, and the returned bills should be produced as vouchers It should be seen that the balance upon the Bills Payable Account in the Ledger is in agreement with the details as shown by the Bills Payable Book

Journal

The Journal should be vouched most carefully, for through the Journal will pass all extraordinary transactions for which there are no special books of first entry The entries appearing in the Journal will be such as all opening entries, for example, the acquisition of the various assets from vendors, the issue and allotment of shares and debentures, closing entries such as the provision for outstandings, depreciation, reserves for bad debts, interest on capital, entries correcting errors, etc , and many other miscellaneous items, such as the writing off of profits or losses upon the sale of capital assets, and various adjusting entries of this nature From the above examples, it will be seen that these items are of a very varied nature, and that they are of great importance, as they may affect the final accounts to a considerable extent It is, therefore, essential that the auditor should vouch thoroughly every entry passing through this book

The actual evidence that the auditor will require will depend upon the nature of the transaction In the case of opening entries recording the acquisition of assets under

a contract, the auditor must inspect the contract, and see that the terms thereof are given effect to correctly in the entries To vouch an allotment of shares in the case of a company, the prospectus, directors' minutes, application letters, contracts, etc, will have to be inspected Provisions for depreciation can be checked only by discussion of the whole question with the management In this way it may be ascertained whether or not, in the opinion of the auditor, sufficient depreciation has been written off The adequacy of the amount reserved for bad and doubtful debts can be verified only by an inspection of the whole of the accounts contained in the Sales Ledgers

The above are only a few examples of the entries to be found in a Journal, together with a rough idea of how some of them should be vouched Later, these matters will be dealt with in more detail, but it will be realized at once how important it is that an auditor should exercise great care when vouching the Journal

Bought Ledgers

The postings to the Bought Ledgers from the Cash Book, Bought Day Books, Returns and Allowances Books, Bills Payable Book, and Journal, will have been checked or tested The castings of the Ledgers should be tested and the balances checked on to the schedules of creditors In the case of creditors from whom goods are purchased regularly, the auditor should see that invoices up to the end of the period have been credited to the account, if not, inquiries should be made The best and most valuable check upon the Bought Ledger balances is the production of creditors' statements, as these prove whether or not the accounts are in agreement with the books of the creditors Of course, in some cases such statements may not agree, as goods may have been debited by the creditor on or before the date of the Balance Sheet, but such goods may not have been received and credited in the books of the auditor's clients until the following period In such cases the auditor should carefully trace such goods through the Goods Inwards Book—confirming the dates—and he should see that these goods have not been included in stock It may be found that certain accounts are in dispute, and,

therefore, the statements disagree—in these circumstances most careful inquiries should be made, and the correspondence should be examined to see that adequate provision is made in the accounts for all outstanding liabilities If claims have been made by a creditor which have not been agreed to or provided for in the accounts, the auditor may have to insist, if the amounts involved are large, upon such claim at least being referred to in the Balance Sheet by way of a note, otherwise he may have to refer to the matter in his audit report In the case of claims that are the subject of a pending lawsuit, the auditor should see that ample provision is made in the accounts for any likely liability under this head, including the legal charges If he is not satisfied with the provision made, the matter will be one that it may be necessary for him to deal with in his report

Any debit balances upon the Bought Ledgers should be carefully examined, with a view to ascertaining that they are bona fide amounts owing, for example, for returns, allowances, etc If any of such debit balances are of long standing, the auditor should go into them with a responsible official, and see that adequate reserve is made for any possible bad or doubtful debts

Sales Ledgers

The postings, castings and balances of the Sales Ledgers should be tested, and checked in the same way as in the case of the Bought Ledgers, but when checking the Sales Ledger balances each account should be scrutinized with a view to ascertaining whether or not the reserve for bad and doubtful debts is a sufficient one The auditor should ask first for a list of the bad and doubtful debts, and a certificate as to the reserve that, in the opinion of the management, is necessary to provide for them

When examining the Sales Ledger Accounts, the auditor should make a note of, or query upon the list of balances, all accounts that appear to him to be doubtful, and which are not included in the list of bad and doubtful debts (if any) supplied to him

If the cash received since the close of the financial period has been posted to the ledger, the auditor may pass as

good all accounts that have been paid since the date of the Balance Sheet, and he may also consider as good all debtors whose accounts are paid regularly, and who invariably take advantage of cash discounts On the other hand, he should query all accounts where any of the following circumstances occur—

(1) Where cash payments are irregular, or where small payments are made on account

(2) Where the balance on the account appears to be increasing, although the trade done is about the same as in the past

(3) Where cheques or bills have been dishonoured, and, therefore, debited to the account

(4) Where bills are constantly being renewed

(5) Where the debt has been owing for a time considerably beyond the period of credit which is customary in the particular trade

(6) Where notes appear upon the account, such as "Account stopped," "in solicitor's hands," "in bankruptcy," or "in liquidation," "disappeared and address unknown," etc

All queried accounts, or such of them as do not appear upon the list of bad and doubtful debts supplied to the auditor, should be gone into with a responsible official, and his explanations asked for A good plan is to have the list of queried accounts ruled with columns headed (1) balance as per ledger, (2) good, (3) bad, (4) doubtful, and a further column for "remarks" As each debt is discussed with the responsible official, it should be extended into the "good," "bad," or "doubtful" column, and, if doubtful, his estimate as to the amount that probably will be received should be noted Upon completion, the columns should be cast, and it should be seen that the reserve for bad and doubtful debts is sufficient to cover the whole of the debts estimated to be bad, and a large proportion of those estimated to be doubtful Such proportion will be based upon the information supplied, and might be from about 40 to 50 per cent of the total doubtful debts, but this depends upon the circumstances of the case In addition, there should be a further provision in respect of the remaining debts that are estimated to be

good, as from past experience it will be certain that a proportion will prove to be bad, probably from 1 to 5 per cent will be a sufficient provision under this head

Reserves for bad and doubtful debts are calculated sometimes by way of a percentage on the total book debts or upon the turnover for the period, however, this method is not recommended, and if it is adopted the auditor should proceed as explained above, and thus satisfy himself that the reserve is a sufficient one

The only way that a reliable opinion can be formed as to the sufficiency of a reserve for bad and doubtful debts is by examining the various debtors' accounts, and inquiring into the circumstances of all doubtful looking accounts This is a most important part of an auditor's duties, for in many cases the total of the book debts amounts to a considerable sum, and the amount of the reserve materially affects the position shown by the accounts The debtors represent sales that have been credited to Trading Account, but which have not been paid for, and if, in fact, part of them are never paid for, instead of such sales representing income, they are an absolute loss, therefore, unless the loss under this head is amply provided for, the profits will be over-stated, as also will be the book debts The difficulty is that this loss has to be estimated, and it is, therefore, of the utmost importance that every precaution should be taken to arrive at as accurate an estimate as possible, and this can only be done by adopting some such method as is described above

If, after completing his investigation under this head, the auditor is of opinion that the reserve is not sufficient, he should put his views before the directors or partners, as the case may be, and hear what they have to say upon the point If, thereafter, he is still of the same opinion, and, nevertheless, the directors or partners refuse to alter the accounts, he should then point out in his audit report that, in his view, the reserve is inadequate These circumstances are dealt with in the cases of *Arthur E Green & Co* v *The Central Advance and Discount Corporation, Ltd* and *The Scarborough Harbour Commissioners* v *Robinson, Coulson, Kirkby & Co*, which cases are discussed in Chapter XI

In cases where fraud is suspected, as has already been stated, it is advisable for the auditors to circularize the whole of the debtors appearing on the books asking for verification of the amounts owing

In certain countries abroad it is the general practice for the auditors as a part of their ordinary programme to circularize debtors in this way Such circularization, if direct with the debtors, is the best possible check as to the correctness of the total of this asset

CHAPTER IX

THE PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

General or Impersonal Ledger

HAVING audited the Sales and Bought Ledgers, the auditor must turn his attention to the Impersonal or General Ledger, the exhaustive checking of which is of the utmost importance The detail postings from the Cash Book and Journal, and the totals from the Day Books, Bill Books, etc, will have been checked, and now the castings of each account should be verified, and the balances checked on to the Trial Balance Each account should be examined carefully, in order that the auditor may satisfy himself that he has checked sufficiently the details making up the balance, and that such items are in order, properly classified, and described in the particular account On no account should this part of the work be carried out mechanically, but keen intelligence must be exercised, as the General Ledger contains a great part of the material from which the Profit and Loss Account and Balance Sheet are built up, and it is the auditor's duty to see that these are properly drawn up, so as to exhibit a true and correct view of the state of the affairs of the concern, and whether this is so or not largely depends upon how accurately and correctly the General Ledger has been kept An auditor should bear in mind, when engaged upon the detail checking of an audit, that every item directly or indirectly affects the final accounts, and, therefore, he must see that the details are recorded and classified correctly, and in such a way that they will find their correct place in the Profit and Loss Account and/or the Balance Sheet. Every account in the General Ledger should be, as it were, alive to him, and the exact nature of all the detail items making up the balance should be appreciated and understood

Grouping Items in Accounts

The Profit and Loss Account and Balance Sheet are summaries, that is to say, most of the individual items included therein are composed of a number of separate

amounts, and it is the duty of the auditor to examine such details and to see that the summarizing and grouping of the items are done correctly He must see that only transactions and items of a like nature are grouped together, that is, that the heading given fairly describes every component item, otherwise, by incorrect classification, the results shown by the accounts may be made to be absolutely misleading For example, this will be the case if revenue charges such as repairs to plant are debited to Plant and Machinery Account, or if, in framing the Balance Sheet, debit balances upon such accounts as Preliminary Expenses, Advertising Suspense, Payments in Advance, and, to take an extreme case, Profit and Loss Account, are included under the heading "Sundry Debtors" For the term "Sundry Debtors" should cover only amounts owing and payable to the concern, such as trade book debts contained in the Sales Ledgers, whereas the items above do not represent moneys owing at all, and are not assets in the ordinary sense, but represent moneys spent, resulting in debit balances, which, as a matter of accountancy, must be carried forward in the Balance Sheet until they are written off to Profit and Loss Account Such items, therefore, should not be included with liquid assets, but should be stated separately and described clearly, so that the exact position of affairs may be reflected

The exact form of the final accounts, the headings under which the transactions should be classified, and the order in which the items should appear in the Profit and Loss Account and Balance Sheet, are all matters of personal opinion, and in respect of which opinions differ The auditor is not concerned with these questions, provided that the position shown by the accounts is a clear and true reflection of the state of affairs He must see that only items of a like nature are grouped together, that there is sufficient subdivision to make the accounts clear and intelligible, and that there is no suppression of material facts

The final accounts are mere summaries built up from, it may be, thousands of detail items, and such accounts disclose the combined effect of all the business transactions that have been carried out during the period of

the accounts—only by going behind the accounts and examining the details can the nature and result of the various transactions be appreciated, and the accuracy of the summaries be verified It is for this purpose, therefore, that the auditor is appointed, namely, that he may examine into all such detail, and thus satisfy himself whether or not all the transactions are in order, and that the accounts are correct summaries, giving a fair reflection of the results of the trading for the period, and the financial position at the date of the Balance Sheet

The Principles Governing the Preparation of Trading, Profit and Loss, and Appropriation Accounts

Auditors have to criticize the form in which accounts are drawn up, further, they often are requested to prepare the accounts, or to give advice in this connexion, and, therefore, although this subject belongs more to accountancy than auditing, it is thought that it will not be out of place to consider briefly some of the principles governing the preparation of the Profit and Loss Account and Balance Sheet, before passing to the detailed work connected with the audit thereof For it is essential that, before criticizing, an auditor must have a correct knowledge of how such accounts should be drawn up, in order that all necessary information may be disclosed in a form that will be easily understood Accountants should not forget that their accounts are not prepared for accountants, but for the information of the general public, and that, therefore, the form of presentation of accounts should be made as simple as possible

The *Royal Mail Steam Packet Co* case was the first one to raise the question of the auditors' responsibilities as regards the Profit and Loss Account Previous to this case the view of the profession was that as the auditor's report referred only to the Balance Sheet, that he was merely concerned with ascertaining that the final balance shown by the Profit and Loss Account did represent a surplus that was available for distribution regardless of the sources from which that surplus had been built up This case has profoundly altered the views of accountants, and these now appear to be that the Profit and Loss Account should

give a true view of the normal earnings of the business during the period under review, and that abnormal items brought to credit, if material in amount, should be shown separately in the Profit and Loss Account In illustration of this point the reader is referred to the Statement of Profits of the Dunlop Rubber Co Ltd which appears in Appendix A For this reason therefore if there have been brought to credit non-recurring items such as transfers from reserves created in past years or in the case of a holding company, if dividends have been declared by subsidiary companies out of profits earned in preceding years, these facts should be made clear in order that a false view may not be given of the current earnings The exact form and wording of the Profit and Loss Account as submitted to the shareholders of a company has therefore become a matter of great importance to auditors, and the guiding principle should be that a misleading view of the normal earnings for the period must not be given to the proprietors of the concern This important problem is dealt with fully in Chapters XII and XIII

It is of the greatest importance that the annual accounts shall be prepared from year to year upon a consistent basis, as otherwise, if the basis is altered, the results shown by the accounts will not be truly comparable with those of preceding years In these circumstances, a misleading view may be given of the comparative earnings It is the duty of an auditor, not only to see that accounts are prepared upon correct accounting principles, but also to satisfy himself that those principles have been applied consistently from year to year If, therefore, the basic principles have been altered and the amounts involved are material, the auditor may be obligated to make these facts clear in his report to the proprietors

Under American practice, it is customary for the auditor to state in his audit report that the Balance Sheet has been prepared in accordance with accepted principles of accounting consistently maintained In the writer's opinion, this practice is one which might be followed with great advantage by auditors in this and other countries

The following is a description of the detail form of the Profit and Loss Account as it would be submitted to management In the case of companies the common practice

in this country is to present to the shareholders a Profit and Loss Account in a very condensed form The question of the form in which it is desirable that the Profit and Loss Account should be presented to shareholders is one upon which opinions differ, but it is one upon which it is most desirable that the profession should attempt to lay down general principles for the guidance of the practitioner

In the case of a merchant, the Profit and Loss Account is divided into three sections, i e Trading Account, the Profit and Loss Account, and the Appropriation Account, and in the case of a manufacturer the Manufacturing or Production Account forms a fourth section Practice differs, but the following is a common basis upon which these accounts are prepared

TRADING ACCOUNT The object of this account is to show the difference between the cost of the goods sold and the proceeds of sale, this difference being the gross profit This account will therefore be credited with the net sales and debited with the cost of the goods sold—i e the invoice price plus direct charges such as carriage and freight inwards, marine insurance, customs duties, landing, dock, lighterage, warehouse charges, etc , as these represent part of the direct cost of the goods, adjustment being made for the opening and closing stocks The following in the author's opinion, is preferable to the ordinary form—

TRADING ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER

Dr.	£			*Cr* £
To cost of goods sold—			By Sales (less Returns)	31,800
Stock (1st Jan)	4,000			
Purchases (less Returns)	28,000			
Carriage Inwards, etc	700			
	32,700			
Less Stock (31st Dec)	6,200			
		26,500		
,, Gross Profit carried down		5 300		
		£31,800		£31,800

By the foregoing form the cost of the goods sold is clearly shown and this figure can be calculated as a percentage of the sales as well as the gross profit

In the case of a manufacturer there is a fourth section, i e Manufacturing or Production Account, which precedes the Trading Account The object of this account is to show the manufacturing cost of the production completed during the period and which thus became available for sale The account is therefore charged with all the works expenditure and charges for the period, adjustment being made for work in progress at the beginning and end of the period The following are the types of items embraced in this account—

Work in progress (commencement)
Raw materials used—i e opening stock, plus purchases, less closing stock
Direct labour
Indirect labour
Power charges
Maintenance of works buildings, plant, tools, etc
Depreciation of works buildings, plant, tools, etc
Stores used
Works heating, lighting, and water
Works rent, rates, and insurance
Works salaries
Works manager's salary
Works general expenses, etc

From this total is deducted the work in progress at the end of the period, and the result gives the works cost of the production completed during the period This figure is carried to the Trading Account, which is in the same form as described above, except that the figure of works cost of completed production takes the place of purchases

PROFIT AND LOSS ACCOUNT This account is credited with the gross profit from the Trading Account, together with any miscellaneous income, such as discounts, interest, rents, dividends, transfer fees, commission, and profit on exchange The debits should be grouped under the headings of (*a*) selling and distribution, (*b*) administration, and (*c*) financial charges, and the total of each group

should be shown, as this greatly improves the form of the accounts for practical purposes Examples of the items to be found under each heading are as follow—

(*a*) Selling and distribution charges—
Dispatch labour
Packages and packing materials used
Carriage, freight, insurance, and export charges
Advertising and publicity
Cost of samples
Salesmen's salaries, commissions, and expenses
Bad debts
Sundry expenses, etc

(*b*) Administration charges—
Clerical and accountancy salaries
Printing and stationery
Office rent, rates, and insurance
Office lighting and heating
National insurances, etc
Postages and cables
Directors' fees and expenses
Managing director's salary and commission
Audit and legal charges
General expenses, etc

(*c*) Financial charges—
Discounts.
Bank and loan interest
Debenture interest
Cost of discounting bills
Discount on issue of debentures
Loss on exchange

Income tax is commonly included in the Profit and Loss Account, it represents an appropriation of profits, however, and more correctly, therefore, it should, in the writer's opinion, be included in the Appropriation Account

APPROPRIATION ACCOUNT The net profit or loss is carried to the Appropriation Account, which account, in the case of a partnership, shows the division of such profit or loss between the partners in accordance with the terms of the partnership In the case of a company, the Appropriation

Account includes the net profit or loss for the period, the balance brought forward from the last period, and any transfers to general reserve, amounts written off preliminary expenses, etc , and dividends paid, the final balance representing the amount available for distribution amongst the shareholders, or the final deficit, as the case may be

In the author's opinion the form of presentation of the accounts of companies is greatly improved by the inclusion in the Appropriation Account and amongst the Current Liabilities in the Balance Sheet of the proposed dividends and also any other appropriations decided upon or recommended by the board This is not the common practice in this country, as the orthodox view is that, as a dividend does not become a legal liability unless and until it is declared, it cannot be included in a Balance Sheet prepared as at a date prior to the Annual General Meeting In theory this argument is unanswerable but for practical purposes the position of affairs is shown in a much clearer form by the inclusion of proposed dividends, and this practice is increasingly being adopted by public companies and has been warmly approved by *The Accountant* and the financial press By this method the final results are shown upon the basis that the shareholders adopt the accounts presented to them and the directors' recommendations as to dividends, etc

In the author's opinion also, the dividends should be shown less income tax and not gross, as is the general practice In recent years an increasing number of public companies have adopted this practice, which, in the writer's opinion, shows a clearer view of the position than does the orthodox method This matter is dealt with fully on page 266, and is illustrated by the Dunlop Rubber Co 's Accounts, which are discussed in Chapter XIII

The forms of account described above are not applicable to non-trading concerns such as hospitals, clubs, trusts, private individuals, etc , and the corresponding account is generally called the Income and Expenditure Account or the Revenue Account, but the object is the same, namely, to group the results of the various revenue transactions of a given period, so that the final profit or loss may be ascertained The exact form depends upon the nature of

the transactions, but the account should be so drawn up as to disclose the amounts receivable from the various sources of income and the various expenses, losses and charges incurred in earning the same

Adjustment of Nominal Accounts

The Manufacturing, Trading, Profit and Loss, and Appropriation Accounts are built up from the nominal accounts contained in the Impersonal Ledger, all such nominal accounts being closed by the transfer of the balances thereon to the four former accounts All nominal accounts must be checked carefully by the auditor, so that he may be satisfied that the whole of the transactions of the business have been correctly classified and included in the final accounts In this connexion, he must see that all outstanding expenses, charges and losses have been brought into the period under review, and that payments in advance and sundry amounts due have been properly adjusted and brought into account The following are examples of various outstanding liabilities —other than Bought Ledger accounts which have been dealt with already—and the methods that an auditor should adopt with regard to each

Provision for Outstanding Liabilities, etc

RENT, RATES, TAXES, GAS, ELECTRICITY, AND WATER, ETC The auditor should inspect ledger accounts, demand notes, and receipts, carefully noting the period covered by each payment and seeing that any accrued and unpaid proportion to the date of the Balance Sheet is provided for He should also compare the amount debited to such account with those included in the corresponding nominal account for the previous year, to see that all the rents, rates and taxes, etc , payable have been included

In the case of a company the current year's income tax assessment must be provided for The income tax liability in this country is in respect of the Government's financial year from the 6th April to the following 5th April If, therefore, a company's financial year ends on the 31st December, it is customary to provide for three-quarters of the current year's income tax liability on the grounds that only that proportion of the liability has accrued

In addition, the Income Tax Account will have been charged with one quarter of the preceding year's assessment An auditor could not take exception to this practice But as the whole of the assessment liability becomes payable on the first day of the coming year, it is financially more prudent to provide for the whole of the current year's income tax liability and this practice is recommended upon policy grounds In these circumstances the amount of the accrued liability up to the 31st December should be included amongst the current liabilities on the Balance Sheet, but the amount provided for the proportion of the income tax liability accruing after the 31st December to the following 5th April might be properly included amongst reserves, as it represents profit withheld from distribution to cover a liability accruing after the date of the Balance Sheet In addition, it is prudent to make a reserve to cover the estimated amount of income tax which will become payable in the future in respect of the past year's profits The auditor could not insist upon this, but it is a prudent course, as a serious financial difficulty may arise if a profitable year is followed by an unprofitable one, when the income tax assessment, based upon the previous year's substantial profits, may press very heavily upon the subsequent year In cases where it is decided to provide for the income tax which will become payable in the future in this way, any such provision should properly be included amongst Reserves, and not amongst Current Liabilities, as here again it represents an appropriation of profits to cover a liability accruing in the future

WAGES The date up to which the wages have been paid should be ascertained, and if there are any days between that date and the close of the financial year, a corresponding proportion of the ensuing week's wages should be calculated and provided for

SALARIES The auditor should inspect the Salaries Account and Salaries Book, and note the dates up to which salaries have been paid, and see that provision is made for any outstanding amounts

TRAVELLERS' COMMISSIONS AND EXPENSES The auditor should inspect the Commission Accounts of the various travellers, and see that any commissions earned to

the end of the financial period but unpaid at that date, are provided for, ascertain the arrangements as regards expenses, and see that any outstandings are brought into account

LEGAL CHARGES Inquiries should be made as to whether there are any amounts owing under this head, if so the auditor should call for the solicitors' bills of costs and see that these amounts are included in the accounts

AUDIT FEE The fee for the period covered by the accounts should be provided for

INTEREST PAYABLE If there are any loans, mortgages, debentures, etc, it is necessary to see that the interest accrued to the date of the Balance Sheet is provided for

SUNDRY EXPENSES All the other nominal accounts should be inspected to see that all the various expenses and charges for the period have been included—these will consist, for example, of repairs, fuel, freight, carriage, dock dues, subscriptions, advertising, and many other items of expense The auditor may be able to trace outstanding amounts by an examination of the receipts and invoices of the amounts debited during the period, noting the dates up to which such invoices run, and making inquiries where such dates fall short of the end of the financial period He may also inspect order books, and an examination of the Cash Book entries and invoice files for the succeeding period often discloses items for which no provision has been made In some cases, where accounts have not been received, the amounts will have to be estimated

CONTINGENT LIABILITIES There may be liabilities that may arise in the future but in respect of transactions effected in the past, such as bills under discount, calls on shares held and not fully paid up, pending litigation, guarantees, speculations, etc The auditor should inquire into any such matters with a view to seeing that adequate provision is made in the accounts for these liabilities and/or that the position is made clear by means of notes upon the Balance Sheet

PAYMENTS IN ADVANCE OR PREPAID EXPENSES Under this head will be included rents, rates, insurances, advertising, subscriptions, etc , paid for periods that extend

beyond the end of the financial year of the particular concern The auditor should examine the nominal accounts and the demand notes and receipts, seeing that a correct calculation has been made of the proportion unexpired at the date of the Balance Sheet

DEFERRED REVENUE EXPENDITURE There may be expenditure of a revenue nature but which equitably may be spread over a period of years, e g abnormal advertising, development expenditure, experimental expenses, alterations to premises and equipment, etc The auditor should carefully investigate the whole of the circumstances in order to satisfy himself that the carrying forward of part of this expenditure is fully justified Payments in Advance are sometimes classified under this heading

SUNDRY AMOUNTS RECEIVABLE There may be various amounts due to the concern, and for which credit should be taken in the accounts, such as rents, interest on loans, dividends, royalties, commissions, taxation claims, shipping rebates, etc , accrued due but not yet received The nominal accounts should be inspected and any available evidence called for to substantiate the amounts that have been provided for as owing, reserve being made for any amounts the receipt of which is doubtful

All these outstandings may be entered in an Outstandings Book, or in the Journal, and the amounts provided should be compared with those of the previous periods, as this may draw attention to any which have been overlooked

The proper provision for outstandings directly affects the Profit and Loss Account, for in this way each nominal account is made to include the exact income or charge applicable to the period of the accounts There is bound to be a considerable amount of overlapping of transactions as between one period and another, but, in order to prepare accurate and exact accounts, it is necessary to draw a line at the date upon which the period closes, and, therefore, all these adjustments have to be made

The Principles Governing the Preparation of the Balance Sheet

The Balance Sheet is an all-important document and it is the one, in the case of a company, to which the auditor has

to attach his report There is a considerable amount of misunderstanding as to what exactly a Balance Sheet is, and what it purports to show, it is, therefore, of the utmost importance that every auditor should understand the true meaning and purpose of a Balance Sheet

DEFINITION OF BALANCE SHEET A Balance Sheet is *not* a statement of assets and liabilities, as is commonly thought, but merely a "sheet" showing a classified summary of all the balances appearing in a set of books, after all the nominal accounts have been closed by transfer to the Profit and Loss Account—the Balance Sheet including, in one form or another, the balance on the latter account The Balance Sheet is not an actual account in the books, as is the Profit and Loss Account, but merely shows, in classified form, the whole of the balances open after the nominal accounts have been closed It should include all the assets and liabilities of the business, but in many cases it includes items on both sides which are, strictly speaking, neither the one nor the other For example if there is a debit balance on the Profit and Loss Account, this balance, in the case of a company, commonly appears on the right-hand side of the Balance Sheet, but this balance cannot be termed "an asset" Again, when expenditure, such as preliminary expenses, discount upon an issue of debentures, advertising, etc, is being written off to Profit and Loss Account over a period of years, the balance carried forward must appear in the Balance Sheet On the other hand, such items as reserve funds, amounts paid on shares forfeited, and, in the case of a company, a credit balance on Profit and Loss Account, must appear upon the left-hand side of the Balance Sheet, but are not what are commonly understood by the term "liabilities"

For the foregoing reasons, therefore, a Balance Sheet should not have the sides headed "Liabilities" and "Assets" for if the right-hand side is headed "Assets" it must mean that every item underneath is an asset, and that the total at the foot represents the total value of the assets of the concern, whereas, as explained above, often this is not the case It is very common, even in the accountancy profession, to head the sides of the Balance Sheet in this way—with the result that many have formed quite erroneous

ideas as to what a Balance Sheet is, looking upon it as simply and purely a statement of assets and liabilities The form in which the Balance Sheet has been presented is largely responsible for this, and, in fact, justifies this false impression These headings have been handed down from the past, and if those who use them were to ask themselves seriously why they have adopted them and exactly what they mean and imply, probably they would see strong reasons for discontinuing the practice

A Balance Sheet should have no headings to the two sides, and, as it is not a ledger account, the signs "Dr " and "Cr " should not appear, nor should the terms "To" and "By" be used, for, as its name implies, it is merely a sheet of balances

If properly prepared, a Balance Sheet should show a true and correct view of the state of the affairs of the concern, and in particular will show exactly the nature of all the assets and liabilities, but it will often include other items as well, and, therefore, these latter should be clearly described so that the whole position may be perfectly clear An auditor's duty is to satisfy himself that the Balance Sheet is properly drawn up upon correct principles, and to report accordingly to those employing him

MAIN OBJECT OF BALANCE SHEET The main objects with which a Balance Sheet is drawn up are to ascertain the financial position at date, and whether the proprietors' capital is intact or not, and how such capital is invested The proprietors' capital represents the excess of assets over liabilities, though, for this purpose, debit balances carried forward upon such accounts as preliminary expenses, advertising suspense, etc , are added to the assets If, therefore, the surplus of assets over liabilities has increased during a given period, this must mean that a profit has been made since the date of the last Balance Sheet, on the other hand, should the surplus be less, a loss must have been incurred But, in comparing the opening and closing capital, for this purpose, it must be seen whether any further capital has been paid into the business, or whether there have been any withdrawals during the period If so, in order to arrive at the profit or loss, the capital additions must be deducted from, and the withdrawals added to, the

closing capital, the resulting figure compared with the opening capital discloses the profit or loss A Profit may be said to be an increase and a loss a decrease in the proprietors' capital invested in a business A Profit and Loss Account merely amplifies the information disclosed by the Balance Sheet, the former showing exactly how such profit or loss has arisen

As the proprietors' capital represents the surplus of assets over liabilities, and as the increase or decrease of such surplus represents the profit or loss, it will be seen that the ascertainment of the profit or loss is absolutely dependent upon the valuation of the assets It is possible, as a rule, to ascertain the amount of the liabilities exactly, except in the case of contingent liabilities, such as claims which are the subject of dispute, in which case the total liability under this head will have to be estimated, but, on the other hand, though the assets belonging to a business can easily be ascertained, it is difficult in many cases to assess their exact value The fixed assets, that is, the assets by the use of which the business is carried on, such as land and buildings, plant and machinery, mines, concessions, etc , are not held with a view to re-sale, and, in fact, may never be sold unless and until the business is finally wound up Consequently, in the meantime, the realizable value of such assets is a matter of estimate and personal opinion Even if expert valuers were employed, probably no two valuers would arrive at the same result--for instance, in the case of a factory equipped with machinery being valued by two independent expert valuers, the respective total valuations might differ considerably In a lesser degree, the same applies to the valuation of stock-in-trade, book debts, and other such assets which are held with a view to more or less immediate conversion into cash And, though it is necessary to estimate their value, it is impossible to guarantee that such valuations will prove to be exact

VALUATION OF ASSETS Another question to be considered in connexion with the valuation of assets for Balance Sheet purposes is whether the valuation should be based upon replacement or realizable values, that is, the amount that it would cost to replace such assets or the estimated amount that such assets would realize if sold, or

again upon the value of such assets to the business as a going concern, that is, their value to the proprietor for the purpose for which he has acquired them As will be seen later, all of these methods are commonly adopted when valuing assets for inclusion in a Balance Sheet

Again, there can be no true profit unless the original capital, together with any additions thereto, is intact, therefore, if any of the assets in which part of such capital is invested are of a wasting nature, or are consumed in the course of earning revenue, such wastage must be made good before the true profit can be arrived at But it is impossible to state precisely what, for example, will be the working life of plant and machinery, or what is the total quantity of ore in a mine, and how long it will take to extract such ore

For the above reasons, it will be seen that it is impossible to arrive at the profits or losses of a continuing business exactly, and actual true profit is seldom ascertained The results are absolutely dependent upon the valuation of the assets of the business, and it is impossible to fix such values with absolute precision These facts must be realized and appreciated by accountants, who should make these root principles clear to their clients, whom they must not lead into the belief that absolute exactitude and certainty can be achieved in the periodical accounts of their business Dealing with this point in a lecture Mr George O May, F C A, stated—

> Financial accounts must always be largely a matter of convention, judgment and opinion—not a matter of certainty Whoever claims more for them is doing a disservice to the investor, the business man, and to the profession itself Certainty would be very welcome in this field just as security in life would be, but it is unattainable and it is mischievous to encourage the belief that it has been or can be achieved
>
> (See *The Accountant*, Vol XCVIII, page 597)

For commercial purposes, the assets are valued according to certain conventional rules, and the profit or loss arrived at in this way is considered sufficiently near and accurate for ordinary business purposes, and, by means of conservative estimates and reserves, well conducted concerns leave a margin to provide against errors in valuation, and for unforeseen contingencies

For Balance Sheet purposes, the assets of a business are divided under two headings, i e "Fixed Assets" and "Floating or Current Assets"

FIXED AND FLOATING OR CURRENT ASSETS

Fixed assets are those assets of a permanent nature which are acquired by an undertaking with a view to earning profits for a period of years by the use of them, and such assets are not held for the purpose of re-sale For example, the plant and machinery of a factory are held with a view to manufacturing with them for the whole period of the working life of such plant

Floating or current assets are those assets which are produced or acquired by an undertaking in the course of or for the purpose of its trading, and consist of cash and such assets as are held with a view to conversion into cash in the regular course of business Examples of floating assets are stock-in-trade, work in progress, book debts, bills receivable and temporary investments, and it will be seen that these assets are those *in which* a trader trades, and a Balance Sheet shows their various stages of conversion into cash, as opposed to fixed assets, which are those *with which* he trades, and which are not held with a view to conversion into cash

Fixed assets are valued upon the basis of cost, and if such assets are of a wasting nature the original cost price in most cases is written off to revenue, by means of depreciation over the period of the estimated working life of such asset At any intermediate date, therefore, the fixed assets will appear in the Balance Sheet at cost, less the depreciation written off to date, and this represents the present value of such assets to the particular undertaking as a going concern, or, in other words, the value of such assets to the proprietors of the particular business Current replacement value, realizable value and break-up value are disregarded, as these do not affect the working lives of the particular assets at all "Replacement value" represents the amount that it would cost to purchase or manufacture a new asset in replacement of the existing one, "realizable value" represents the amount that an asset would produce if sold in the open market, and "break-up value" is the amount that would be realized by a

forced sale under the hammer, in the case where the business is closed down. Fixed assets are not valued upon their saleable value, but upon their value to the proprietor of the business—in other words, upon their ability to earn profits, and not upon their intrinsic value. It will be seen, therefore, that such Balance Sheet values are more or less hypothetical, and that there is a likelihood of error, for it is impossible to fix, with absolute certainty, the period of the working life of a fixed asset. If errors are made, the profit or loss will be affected immediately. On the other hand, the fluctuation in realizable or replacement value of a fixed asset does not affect the proprietor, except at the end of the asset's life, when it may have to be replaced, in which case the price of the new asset may be more or less than the cost of the original one. But, apart from this, such fluctuations are immaterial, for they do not add to or reduce by a day the period during which such assets will earn revenue, and, provided the original cost has been written off during this period, the results shown by the accounts have been, for practical purposes, sufficiently accurate.

Floating or current assets should be valued for Balance Sheet purposes with regard to their realizable value, as they are held with a view to conversion into cash. These assets, as a general rule, should therefore be valued, in the case of stock-in-trade or inventories and temporary investments, at cost, and book debts and bills receivable at book value or in all cases the present realizable value, whichever is the lower at the date of the Balance Sheet. Upon this principle, therefore, a merchant's stock-in-trade should be valued at cost or net realizable value, whichever is the lower, and in the case of book debts and bills receivable adequate reserves must be made for bad and doubtful debts.

On no account should floating assets be valued above cost price, as the effect would be to take into account an unrealized profit. For if certain goods are purchased for £500, and remain unsold at the date of the Balance Sheet, when the realizable value of the same is £600, it cannot be said that a profit of £100 has been made, but merely that if these prices are maintained it appears likely that, upon realization, such a profit may be made. Again, if such goods were valued at £600, apart from other transactions, the

accounts would show a profit of £100 available for the proprietors of the business, but, in fact, there would not be, at the date of the Balance Sheet, a penny piece representing such supposed profit, which, therefore, would be a mere paper one

The foregoing reasoning might be used to argue against the necessity of writing down the value of stock-in-trade in cases where the net realizable values are below cost But accounts should be prepared upon the basis that unrealized losses should be anticipated, but unrealized profits upon stock, etc, should not be anticipated, for if provision is made for an estimated loss, and it subsequently transpires that this estimate was incorrect, and that, in fact, the transaction resulted in a profit, no harm will have been done, and the succeeding year will benefit to the extent that the previous year's profits were under-estimated But, on the other hand, if a profit is anticipated and taken credit for before it is realized, then such estimated profit may have been paid away to the proprietors of the business, and upon it being found subsequently that this profit was unjustified, the transaction having resulted in a loss, it may be impossible to recover from the proprietors this over-payment, and, consequently, the capital of the business will be reduced to the extent of this over-estimation of profit in the past

The foregoing principles as regards the valuation of fixed and floating assets are based upon what are considered to be the accepted principles of sound financial policy In this connexion the chief point is that the main purpose of the Profit and Loss Account is to ascertain the amount of the profits available for distribution to the proprietors of the undertaking

Auditor's Position as Regards the Valuation of Assets

From the foregoing, it will be seen how dependent the Profit and Loss Account and Balance Sheet are upon the valuation of the various assets of a concern, but it must be observed that an auditor cannot possibly value the assets of the businesses whose accounts he audits This valuation must be carried out by the partners, directors, or other responsible officials, all that an auditor can do is to

ascertain as far as possible that such valuations appear to him to be fair and reasonable, that they are based upon correct principles, and that all contingencies appear to have been provided for. In the case of some assets, such as investments in securities of which there are market quotations, the auditor can check the valuations exactly, but in the case of others, such as land, buildings, plant and machinery, there is no means by which he can determine the precise value. The steps that an auditor should take, in order to satisfy himself that the valuations appear to be fair and reasonable, will be discussed in the course of the following chapters, but, before proceeding further, the limitations of a Balance Sheet and the limitations of an audit, especially with regard to the valuation of assets, should be clearly understood and appreciated; accountants should not claim for an audited Balance Sheet absolute exactitude, but merely that it shows the fairest possible estimate of the position of affairs, arrived at in accordance with the accepted rules, and checked and tested in every reasonable manner. On no account should the impression be given that an audit guarantees that the position shown is correct in every detail, for the future may show that the most carefully prepared and audited Balance Sheet has, in the light of after events, considerably mis-stated the real position of affairs. Great harm only can be done to the profession if accountants assume for an audited Balance Sheet virtues that it does not and cannot possibly possess.

Form of Balance Sheet

There is no standard form of Balance Sheet, except in the cases of railway, electric light, gas, water, and insurance companies. With the ordinary industrial and trading companies this matter is left in the hands of the directors, who are responsible for the form in which the Balance Sheet is presented, subject, however, to the provisions of the Companies Act, 1929, which are dealt with in Chapter VIII. The auditor has no power to alter the form of the directors' Balance Sheet, although his advice is generally taken, but if, in his opinion, the form is such that the Balance Sheet is misleading and does not show a true view

of the company's financial position, then the auditor must report to this effect to the shareholders

The broad outlines upon which a company's Balance Sheet should be prepared are, in the writer's opinion, that on the one side should be grouped (*a*) the interest of the shareholders—i e the share capital, general reserves, and undistributed profits, (*b*) fixed term loans, such as debentures, and (*c*) current liabilities—e g short term loans, trade creditors, bills payable, accrued expenses, taxation provisions, proposed and unclaimed dividends, etc The form of the Balance Sheet is greatly improved if the items under each of these headings are grouped, showing the sub-totals

On the other side also, the items should be grouped showing (*a*) fixed assets—e g land and buildings, plant and equipment, furniture and fixtures, permanent investments, patents, trade marks, and goodwill, (*b*) floating or current assets—e g cash, bank balances, temporary investments, book debts, bills receivable, inventories, etc , and (*c*) intangible items, e g preliminary expenses, deferred revenue expenditure, underwriting commissions, discount on issue of debentures, experimental and development accounts Some prefer to include patents, trade marks and goodwill under this heading

When there is a debit balance on Profit and Loss Account in the case of a company, this is commonly shown on the right-hand side of the Balance Sheet, but, in the author's opinion, the position is reflected far more clearly if this debit balance is shown as a deduction from the share capital, so that the present value of the shareholders' interest is clearly revealed

If the Balance Sheet is grouped in this way, showing the sub-totals, the chief aspects are clearly revealed, as it can be seen at a glance what proportion of the total capital available is invested in fixed assets, current assets and intangible items, and what is the working capital The ratio of the total current liabilities to the total floating or current assets is one of the key points in the reading of every Balance Sheet

In the opinion of the author, the form in which accounts in this country are commonly presented is capable of

considerable improvement, and it is obviously important that accountants should study this subject, with a view to presenting accounts in as clear and concise a form as is possible It is suggested that the difficulties of the layman in understanding accounts are largely due to the form in which they are commonly presented

Readers who wish to study modern views upon this important subject are strongly recommended to read a paper by Mr George L C Touche entitled "The Form of the Balance Sheet" (*The Accountant*, Vol LXXXIX, page 17) In this paper Mr Touche points out the defects of the traditional form of Balance Sheet and makes suggestions for improvement, illustrating his points with three *pro forma* Balance Sheets In increasing numbers public companies are commencing to present their Balance Sheets upon these lines and every accountant should, therefore, keep in close touch with this movement

In Appendix A the Reports and Accounts of the Dunlop Rubber Co Ltd, Dunlop Plantations Ltd, and Dunlop Cotton Mills Ltd, are shown as an illustration of a modern form of presentation, which is discussed, in Chapter XIII

The provisions of the Companies Act, 1929, as affecting the accounts of companies, are dealt with in Chapter VIII

In *The Accountant* of the 19th May, 1934, page 698, there is reproduced a series of letters between the American Institute of Accountants and the New York Stock Exchange Readers are strongly recommended to read this correspondence as it deals with nearly all of the fundamental and basic considerations in connexion with the Profit and Loss Accounts and Balance Sheets of companies

CHAPTER V

VALUATION AND VERIFICATION OF ASSETS

General Considerations

In the preceding chapter it has been pointed out that the values of most of the assets of a business for Balance Sheet purposes have to be *estimated*, that such valuations are bound in many cases to be more or less approximate, and that they are not in all cases based upon the realizable values, but upon certain accepted rules On the other hand, it must be recognized that the Balance Sheet is absolutely dependent upon the valuation of the assets, and that, therefore, this matter must be gone into with the utmost care, so that the results shown may be sufficiently accurate for all practical purposes It is now proposed to deal with the valuation of various common assets which are constantly met with in practice, and to explain the auditor's duties with regard thereto But it must be borne in mind that the actual valuations are made by the proprietors or officials of the concern, who have a practical knowledge of such assets, and that an auditor's duty is confined to testing the valuations as far as he can, and in this way satisfying himself that the position shown appears to be correct, he cannot, however, in any way guarantee the accuracy of the valuations

At the same time, the auditor's duties as regards the verification of assets will also be discussed The assets of a business will be ascertained from the books of account, and it is the auditor's duty to see that all those thus disclosed are properly and clearly set out in the Balance Sheet, and appear to be correctly valued But this is not sufficient, for, having found from the books what assets ought to be in the possession of the concern, he must then satisfy himself that such assets were actually in its possession at the date of the Balance Sheet, and that they were free from all charges except those disclosed in the books This is a most important part of an auditor's duties, for, although he may have vouched the original payment upon the purchase, that is no evidence at all that that asset was still in the possession of the concern at a subsequent date. The auditor, therefore,

should attend at the close of the period for the purpose of verifying the assets as at that date This entails the inspection of such evidence as will satisfy the auditor that such assets are actually in the possession of his clients

When examining securities for this purpose, care and method must be adopted to prevent substitution, that is to say, that when, for example, there are two or more securities of a like nature, one batch of securities is not produced to verify both investments If considerable care is not exercised, this fraud is extremely simple For instance suppose the case of a company holding as an investment certain debenture bonds, having in all one hundred £50 bearer bonds, unless all these bonds are produced at the same time, the verification will be useless—for if the auditor had one batch of fifty produced to him by the manager, who thereafter took these away, and then produced another batch of fifty, it would be impossible, unless the auditor noted all the numbers upon the bonds produced, to ensure that the same bonds were not produced twice In fact, this particular form of fraud in the past has been perpetrated for years in succession, covering up serious defalcations Therefore, when examining securities, such as the title deeds of freehold and leasehold property, share certificates, bonds, bills, etc , the auditor must see that the whole of the securities are produced to him at one time, and that all remain under his entire control during the whole of the time of his examination A simple way of doing this is to have all the keys of the strong room and safes, where the securities are kept, handed to the auditor at the commencement, and these he should retain in his possession until he has completed his examination of the securities Further, he should conduct the whole of the examination himself, assisted by his own staff, and as little as possible by the staff of his clients

Cash in Hand

The auditor should attend at the close of business upon the date of the Balance Sheet, or on the following morning, and count all cash balances in hand, comparing them with the balances according to the books If there are two or more cash balances, such as petty cash, cash in till, etc , the whole of the cash should be produced at one and the same

time, in order to prevent shortages upon one account being made up out of the cash belonging to another

If the auditor cannot attend immediately upon the close of the financial period for the purpose of counting the cash, he should, when he subsequently attends, check and vouch the petty cash, till books, etc , up to date, and then count the cash, comparing it with the balances shown by the books

A very good plan is to arrange that all cash balances at the close of the financial period shall be paid into the bank upon the last day of such period, cheques being drawn upon the following day to re-open the cash accounts In this way all cash balances are automatically counted and accounted for, and the auditor is thus saved from a somewhat invidious task

Where it is known that the auditor proposes counting the cash balances upon a given date, it is very unlikely that he will find anything wrong A far more effective check is to call for the production of balances without notice during the course of the year

If a cashier has misappropriated cash he will make every effort to "beg, borrow, or steal" the amount necessary to make up the cash balance for production to the auditors The writer has knowledge of a case in which the cashier, being pressed by the auditors for the production of his cash balance, abstracted a cheque at the end of the cheque book which he made out for the amount that he had previously misappropriated. He obtained a director's signature to this cheque on the ground that the money was required to pay employees their holiday savings This case clearly illustrates the vital importance of verifying the whole of the cash and bank balances at one and the same time If this is not done it is always possible for a defaulting cashier, if he is given time, to make up a deficiency in one fund out of the balance in another

Unless absolutely necessary, large cash balances should not be allowed, and if cash balances show a tendency to increase, the auditor should make careful inquiries as to the necessity for them and their actual existence, and bring the facts to the notice of the principals of the business

In the case of the audit of a large bank the counting of the

cash balances is a considerable undertaking In practice, as a rule, the cheques and notes are counted by the auditor, the gold is weighed and the bags of silver and copper are counted, a few of the bags being opened and weighed

Bank Balances

The Cash Book should be checked with the Pass Book as previously described, and the two balances agreed by means of the reconciliation statement Thereafter, a certificate should be obtained by the auditor direct from the bankers, verifying the balance according to their books at the close of business upon the date of the Balance Sheet, it being seen that this balance agrees with the balance according to the Pass Book produced Any balance upon "Deposit Account" should be verified in the same way When applying to the bank for this verification statement, the auditor should ask for particulars of *all* balances standing in the name of his client, as there have been cases in which there were banking accounts in existence that were not disclosed to the auditor The auditor should also ask for particulars of any bills or securities held by the bank on behalf of his clients

Investments

When possible, the best way to deal with investments is to have a separate account opened in the ledger for each investment the amount debited being the actual cost If shares or debentures have been issued to the concern as consideration for services rendered, then whatever outlay has been incurred in connexion with such services, should be debited to the particular investment account, as representing the actual cost of the shares or debentures received If, however, there are no such expenses or outlay, an account should be opened for such shares or debentures, but no amount should be placed in the cost column In this way every investment appears in the books at the actual bare cost, and remains at this figure until sold, when the amount realized will be credited to the particular account, and the profit or loss upon realization will be ascertained thus and written off

At the date of each Balance Sheet, a schedule should be

prepared and presented to the auditor, giving particulars of each investment, the cost thereof according to the Ledger, and a fair valuation at the Balance Sheet date, based upon current market prices For the purpose of this valuation, temporary market fluctuations are in certain circumstances disregarded, for example, if upon the date of a Balance Sheet all markets were abnormally depressed owing to a war scare, which, by the time the audit is being completed, has subsided and the markets have righted themselves, it would not, it is submitted, be necessary to value upon the basis of such abnormal prices, but a fair average price should be taken But, except in exceptional circumstances, such as the above, each investment should be included on the list at the market price as at the date of the Balance Sheet

In the case of holding companies, the investments in subsidiaries are a fixed asset, as these investments are not held with a view to sale The question of the valuation of the shares of subsidiaries is dealt with in Chapter XIV

The two columns on the schedule, that is, the cost and the market value, should be added and if the total of the re-valuation equals or exceeds the total cost, then the investments as a whole should appear in the Balance Sheet at cost, but if the total of the revaluation is less than the cost value, the question arises as to whether or not a reserve should be made to provide for this estimated shrinkage in value The provision of such a reserve is obviously prudent Any such provision should be debited to the Profit and Loss Account, and shown in the Balance Sheet as a deduction from the total cost of the investments The question whether, in the case of a company, it is legally necessary to provide for such a depreciation in value, will be considered in Chapter X, but there can be no question that this is a very wise course to adopt, though it must not be thought that investments must invariably be written down to the market value at the date of the Balance Sheet, for in some cases investments may be held for many years, during which time the market values may fluctuate between very wide margins, but, until they are finally sold, no actual profit or loss arises The best method is to deal with the investments as a whole, and to make a reserve to cover any likely losses upon realization

If reserve is not made for depreciation in market value, then in such circumstances the investments should be shown in the Balance Sheet at cost, with a note against the item as to the market value at the Balance Sheet date

In all cases the basis of the valuation should be stated upon the Balance Sheet, that is, as to whether the valuation is "at cost," "market prices," or "at cost less a reserve," and, further, the investments should be subdivided in the Balance Sheet in such a way that a fair idea is given of their nature—that is to say, there should not be one item "investments" in the Balance Sheet which includes investments of widely different classes, as, for example, Government stocks and holdings in small private companies, but if a detailed list of the investments is not given, holdings of a like nature only should be grouped together, and these should be adequately described, so that the Balance Sheet may show what proportion of the total is invested in what are commonly called "gilt-edged" securities, and what proportion in speculative investments, in connexion with which the risk of loss is very much greater

So far as the auditor is concerned, he should check the list with the ledger, and check the valuations, seeing whether or not an adequate reserve has been provided against possible losses upon realization If no such reserve is made, he should see that a note as to the market value appears upon the Balance Sheet, or that the investments are distinctly stated as being "at cost," and, if the fall in value be material in amount, he should refer to the matter in his audit report On no account should investments appear in the Balance Sheet at a value above cost, such estimated increase being credited to Profit and Loss Account, as if this is done credit will be taken for what is but an estimated and "paper" profit, such supposed profit not being represented by a penny piece with which, in the case of a company, a dividend could be paid

As regards the verification of investments, the procedure will be as follows—

INSCRIBED STOCKS An application must be sent to the banker or agent's office where the stock is inscribed, such application being made upon official forms, which must be signed by one of the stockholders, details must be given as

to the nature of the stock, the amount held, the names in which it is held, the date at which it is to be certified, and to whom the certified form is to be sent, who, for this purpose should be the auditor The form must also be accompanied by the prescribed fee for verification The banker or agent then compares the particulars with the records in his books, and if found to agree, certifies the form as correct, and returns it as directed For audit purposes, application will have to be made in the same way each year When inscribed stocks are bought, the purchaser is given by the banker or agent a certificate that the same have been duly inscribed, but as this certificate has not to be produced when the stock is sold, it is of no value to an auditor, and on no account should it be accepted as a verification of such holding at a subsequent date The following are a few examples of inscribed stocks that will have to be verified in this manner Consols, War Loan, conversion stocks, annuities, London County Council stocks, local loans, India 3 per cent and 3½ per cent stocks, various Municipal and Colonial stocks

DEBENTURES AND REGISTERED SHARES IN COMPANIES The debentures or share certificates must be inspected, it being noted that they are made out in the names of the auditor's clients or their nominees—in the latter case, a certificate should be obtained from the nominees that they hold for the auditor's clients, and that they have no charge upon such investments

In the case of new issues, in respect of which debenture or share certificates have not yet been issued to the holders, the auditor will require to see the allotment letters and the bankers' receipts for the instalments that have been paid

DEBENTURE BONDS AND SHARE WARRANTS TO BEARER The bonds or warrants should be inspected, it being seen that all unpaid interest or dividend coupons are attached

Book Debts

The auditor's duties as regards this asset have been dealt with already in connexion with the audit of the Sales Ledgers, his object being to satisfy himself that the amounts shown as owing appear to be bona fide debts, and that a sufficient reserve is provided for bad and doubtful debts In the case

of a company, Section 128, Companies Act, 1929, provides that loans to directors and officers of the company must be shown separately in the Balance Sheet

Bills Receivable

A schedule of the bills in hand at the date of the Balance Sheet should be produced to the auditor, and he should compare the list with the Bills Receivable Book, and see that the total of the list agrees with the balance upon the Bills Receivable Account in the ledger He should then examine all the bills actually in hand, noting that they appear to be properly made out, completed and stamped, and that they are not overdue If certain of the bills are in the hands of the clients' bankers for collection, the bank should be requested to supply the auditor with a certified list of such bills If the audit is not completed until some time after the date of the Balance Sheet, a proportion of the bills probably will have matured, and the cash for these should be traced into the Cash Book and Pass Book, and any that have been dishonoured or renewed will thus be discovered, in which case careful inquiry should be made as to the reserve necessary to provide against possible bad debts With regard to the balance of the bills that are still current at the time of the audit, the auditor should go through the list of these with a responsible official, and inquire as to the sufficiency of the reserve (if any) that has been provided under this head

The total amount of the bills receivable is, in many cases, considerable, and, therefore, the auditor must satisfy himself that it is a good asset, and that an adequate reserve has been provided for possible losses through bad debts

If any bills are under discount at the date of the Balance Sheet, the auditor should require a list of such bills, and he should compare this list with the entries in the Bills Receivable Book The total amount of the bills under discount should appear as a contingent liability, being shown by way of a note upon the Balance Sheet Inquiry should be made as to whether any of the bills that have become due since the date of the Balance Sheet have been dishonoured, and, if so, as to the reserve necessary to provide for any anticipated bad debts

Goods on Consignment

This asset should be very carefully verified, and it should be seen that proper accounts are kept with reference to each consignment, that is to say, that in each case there should be a Consignment Account and a Personal Account with the agent, the former being practically a Trading Account showing the profit or loss upon the particular consignment, and the latter a personal account comprising amounts due to or by the agent

The duplicates of the debit notes should be compared with the Consignment Account, so as to ensure that the goods and expenses have been debited at cost price The accounts sales received from the agent should be checked, to see that the gross sales have been credited to the Consignment Account and debited to the agent, and that the agent's expenses and commission have been debited to the Consignment Account and credited to the agent's account

If at the date of the Balance Sheet the whole of the goods have not been sold, the agent should send certified stock sheets showing the goods in hand at that date, and the auditor should carefully examine these stock sheets The stock should be valued at cost price, plus freight and charges, full allowance, however, being made for depreciation if the goods have deteriorated or been damaged The stock valuation will be brought down as a debit balance upon the Consignment Account, and if a loss has been incurred upon the goods sold to date, it must be written off to Profit and Loss Account, and must on no account be brought down in the balance upon the Consignment Account The figure in the Balance Sheet should represent only the stock in hand at a fair valuation

If the Consignment Accounts have not been kept as suggested above, these transactions will require very careful scrutiny, especially in order to see that no profit has been anticipated in respect of goods sent to agents, but not yet sold, that any losses to date upon goods sold have been written off, that stock unsold is brought into the Balance Sheet at a fair value, that all expenses and commissions due to agents have been provided for, and it is better to show balances due from agents separately upon the Balance Sheet, and not include them among Sundry Debtors

The auditor should make inquiries to see that ample reserves have been provided for possible bad debts, and, therefore, any long-standing debit balances upon the agent's or Consignment Accounts should be most carefully inquired into In the case of businesses selling goods abroad in this way, the losses at times, owing to the default of agents, are very considerable, and, therefore, great care should be exercised when dealing with these transactions

Uncompleted Contracts

Partly manufactured goods have been dealt with above under the head of Stock-in-Trade, and what have now to be considered are uncompleted contracts, in the case of builders, engineers, shipbuilders, public works contractors, and similar businesses For Balance Sheet purposes, the general rule is that work in progress should be valued at cost—that is, the wages, materials and direct charges expended thereon to date, and, in addition, a reasonable sum for overheads, that is, a percentage added to cover the various indirect charges of the business, such as supervision, works rent, rates and taxes, depreciation of plant and machinery, indirect wages, such as those of foremen, storekeepers, yardmen, etc A percentage is also sometimes added to cover administration expenses, such as director's fees, staff salaries, office rent, rates and taxes, etc , though for Balance Sheet purposes it is wiser to omit the latter In this way, the actual cost of the work to date is carried forward to the succeeding period, and no profit is taken credit for in respect thereof If however it is anticipated that eventually a loss will be incurred upon any contract, then the cost figure must be reduced, so that such loss is provided for

In the Balance Sheet the uncompleted contracts should be shown as a separate item, and any cash received on account thereof should be shown as a deduction

In practice, profit is sometimes anticipated, and although, theoretically, this may not be considered correct, it is a well established custom which in proper circumstances an auditor may pass This practice is commonly adopted in the case of large contractors, where the individual contracts often extend over periods of some years If, therefore, they only took credit for the profits when the contracts were completed,

the results shown by the general Profit and Loss Account would vary very considerably from year to year, for in one year a number of profitable contracts might run out, with the result that the Profit and Loss Account would show a large profit, but in another year, though there might be several large and profitable contracts running, and in respect of which considerable sums of cash have been received on account, yet very few contracts might have been completed during the period, and, therefore, owing to the Profit and Loss Account having to bear considerable standing charges, the accounts might show a loss Therefore, to even the results from year to year, profits are commonly anticipated But, where this is done, very great care must be exercised in estimating such profit, and ample reserves must be made for contingencies, for it must be borne in mind that a contract may be progressing normally, and present figures indicate that a considerable profit will be earned, but some unforeseen contingency may arise, such as a strike, collapse of part of the works, rise in the price of raw materials, flooding in the case of the building of a tunnel, failure to complete in the contract time and thereby incurring heavy fines, and many other such circumstances, which may result in the contract eventually showing a considerable loss

Profits should be anticipated only when the contract is so far advanced that the cost to complete can fairly be estimated, and thus the probable eventual profit arrived at Therefore, all contracts that are in an early stage should be invariably valued at cost. When the results of the contract can be reasonably estimated, a heavy reserve should be deducted for contingencies, for example, the proportion of the final profit, according to the proportion of work completed to date, should be calculated, and it is suggested that about one-third of such profit should be reserved, the remaining two-thirds only being taken credit for The apportionment of the estimated profit upon an uncompleted contract is commonly calculated in the same ratio as the wages expended to the date of the accounts bears to the estimated total wages upon the contract Another most important point is, as to whether the cash received under the contract has been sufficient to warrant the anticipation

of profit, for if, for example, the cash received is less than the actual expenditure upon the work to date, and there is no cash receivable in the immediate future, then if a profit is anticipated, upon the strength of which dividends are paid to shareholders, or profits paid out to partners, the result of such payment of dividend or profit must be that the working capital of the concern is reduced by reason of this anticipation and withdrawal of profits that have not been, in fact, received in cash Therefore, the cash position should be considered most carefully in all cases, and in a small business, having only a small working capital, it is a very unsound policy to anticipate profit upon uncompleted contracts at all, as the result may be that the working capital is reduced, and a serious financial position may thus be created, there not being sufficient funds in hand to complete the contracts Large contracts require very careful financing, and, therefore, this point should never be lost sight of

The auditor should go into the whole question of uncompleted contracts most carefully, comparing the Balance Sheet figures with the Cost Books If proper Cost Books have been kept, these will be of great assistance, especially if they have been subject to an efficient internal check, as in such case they will afford a very valuable check upon the valuation of the uncompleted contracts If, however, there are no reliable Cost Books, the auditor should insist upon full particulars being supplied as regards all uncompleted contracts, showing exactly how the results have been arrived at, and these he should check as far as possible with whatever evidence there is available

The auditor should check the castings and test the calculations of the sheets, see that the latter have been initialed by all who have taken part in their preparation, and that the uncompleted contracts are certified as a whole by a responsible official The auditor should carefully inquire into the whole system for valuing this item in the Balance Sheet, and the basis upon which such valuation has been made He should carefully inquire into any "overheads" added If profit is anticipated, he should investigate the figures most thoroughly, and in this case he should insist that the Balance Sheet and accounts should disclose the fact that the

uncompleted contracts include anticipated profit, if this is not made clear in the accounts, then the auditor should point out this important fact in his audit report

The auditor is bound to be very much in the hands of the management when dealing with this asset, but he should endeavour to check and test the figures as far as he reasonably can, and if he is not absolutely satisfied, he should report to that effect to the shareholders or partners, as the case may be (see *Smith* v *Offer and Others*, page 220) If the value of the uncompleted contracts has been falsified deliberately by, say, the managing director, in all probability it will be impossible, in the ordinary course of an audit, to discover the whole extent of this fraud, but careful and intelligent investigation may be sufficient to lead the auditor to the conclusion that the valuation of this asset is unsatisfactory, and that the results are not reasonable, and if, therefore, he reports to this effect, the proprietors of the concern may thereupon institute a much fuller investigation, which may result in the true facts being ascertained

Plant and Machinery

Plant and machinery is not valued upon the basis of its realizable or replacement values, but upon the basis of its value to the particular business as a going concern, in other words, the value is based upon its earning capacity

The cost price of plant and machinery, less any "scrap" or residual value, should be written off to revenue over the period of the estimated working life of the asset The estimated working life is, of course, the unknown factor, and it requires the technical knowledge of an engineer to fix this period, and in this respect the auditor must be largely in the hands of the engineer

The realizable or replacement values of similar machinery may be disregarded, for the plant of a manufacturer is held solely for the purpose of manufacturing with the same for the whole of such asset's working life, and this period is unaffected by fluctuations in the replacement values The "break up" or realizable values are also disregarded, for this asset is not held with a view to re-sale A considerable portion of the plant and machinery has, as a rule, very little realizable value, for example, shafting, if pulled out, will

realize a very small proportion of original cost Again, machinery specially manufactured for a patent process might be of no value to any other concern New machinery that has been just installed immediately becomes "second hand," and the realizable value is considerably less than cost

All these circumstances, therefore, are disregarded, and, provided that the cost price is written off to revenue by means of depreciation over the period of the asset's working life, during which it is earning income, the balances appearing in the accounts of intermediate years are absolutely correct ones, according to the accepted rules upon which Balance Sheets are prepared By means of provision for depreciation, revenue is withheld and retained in the business to replace the capital that has been sunk in the purchase of the plant, which capital otherwise would be lost upon the expiration of the life of the asset

In some cases, plant and machinery is re-valued for Balance Sheet purposes, in which case the certified valuations should be produced to the auditor, but this practice is very uncommon However, it is a very good plan indeed to have plant re-valued occasionally, in order that the amounts of depreciation written off may thus be roughly checked For it must be borne in mind that it is quite impossible to fix, with absolute certainty, the period of the working life of plant, machinery, and similar assets

In the case of equipment being purchased under a Hire Purchase Agreement or an agreement to pay by instalments the depreciation should be calculated upon the original cash value, and not upon the amount of the instalments paid to date

The verification of plant and machinery by the auditor is a matter of some difficulty, in fact, it is impossible to verify this item with any degree of certainty, as is the case with some of the other assets Upon the purchase of the individual items, the auditor will vouch the payments in the ordinary way with invoices, receipts, etc , and all additions during the period of the accounts should be thus vouched, careful inquiry being made to see that such items do, in fact, represent bona fide additions to capital Replacements also must be carefully inquired into, with a view to ascertaining that the old

asset has been entirely written out of the Plant Account before the new asset is debited in its place

There should be a plant register, or a schedule of the plant and machinery certified by the engineer, and, if so, this should be called for by the auditor

In the case of plant and machinery abroad, the auditor should require that the local engineer should furnish a report upon the plant as at the date of each Balance Sheet, reporting whether the same is in a proper state of working efficiency, and also as to the adequacy of the provisions for depreciation

The auditor should discuss the whole question of depreciation fully with the management, and thus endeavour to ascertain the basis upon which they have founded their estimates and provisions, and whether they have acted upon proper advice It is impossible for an auditor to value or estimate the working life of plant, all he can do is to make inquiry and thus satisfy himself whether or not this most important question appears to have been properly faced and considered, that correct principles have been acted upon, and that the provision made in the accounts appears to be reasonable and sufficient. It is often found that the provisions for depreciation have been fixed haphazard, and without regard to any of the considerations and principles governing the question, and, in such cases, and when the auditor is not satisfied that the depreciation is sufficient, he should point this out clearly in his report

If plant registers are kept, these in course of time will reveal the actual experience of the working lives of the various types of plant Such registers therefore are of the utmost value to the auditor in satisfying himself whether the provision for depreciation is adequate or not

The whole question of depreciation will be considered at length in Chapter VII, but the foregoing will perhaps be sufficient to indicate the lines upon which an auditor should deal with this asset in a Balance Sheet

Loose Tools, etc

As the working lives of the various items coming under this head in many cases are very short, and replacements, renewals and additions are constantly having to be made, the only really satisfactory way to deal with this asset is to make

a re-valuation each year, in which case this item is dealt with in the same way as stock-in trade, the auditor examining the certified valuations, and checking and testing them as far as possible. The basis of valuation is not the current realizable or replacement value of the tools, but cost less an adequate allowance for wear and tear.

Furniture, Fixtures and Fittings

Furniture should be dealt with as in the case of plant and machinery, and adequate depreciation should be written off, based upon the working life. The working lives of such items as safes, desks, tables, etc., are often very long, but fixtures and fittings, such as partitions, bookshelves, electric wiring and fittings, have a short working life, and should be written off according to their estimated lives, except in the case of fixtures and fittings upon leasehold premises, in which case the whole should be written off over the period of the lease or their estimated life, whichever is the shorter.

Horses

Horses should be re-valued each year, the certified valuation being produced to the auditor, or the average working life of a horse should be estimated, which, for example, in the case of cart horses working in a city, is commonly reckoned to be about five or six years. A Horse Register should then be kept, in which each horse is entered when purchased, full particulars as to age, description and cost being given; each year the value of each horse should be reduced by (say) one-sixth of the original cost price, and in this way the total depreciation is arrived at. Upon death or sale, after crediting in the register any amount realized upon the sale of the carcass or live animal, any resulting debit balance should be written off as a loss. In the event of profits being made upon sales, these should be credited against losses upon death or sales. The Horse Register will show the details making up the balance upon the Horse Account in the Ledger, and should be examined and compared therewith by the auditor, who should also see, in the light of actual experience, whether the estimated working life appears to be working out correctly.

Carts and Vans

Carts and vans should be dealt with in the same way as plant and machinery, and owing to the extent to which the working life may be extended, by means of repairs and renewal of parts, the rate of depreciation may be low But in the case of motor lorries and vans the depreciation of the engines is fairly rapid, and as the initial cost is considerable the methods applied to these should be carefully inquired into by the auditor

Harness

Harness should be dealt with in the same way as loose tools, and re-valued, and in practice it is not uncommon for each complete set of harness to be valued each year at a fixed value, such fixed amount being a low average value, and new and old sets are all valued at the same average figure Provided the fixed valuation is a fair one, this latter is a very simple and effective way of dealing with such assets

Freehold and Leasehold Land and Buildings

Land should appear in a Balance Sheet at cost price, and should not be written up, even though the neighbourhood may be improving and values increasing, for, in the case of land upon which a factory or works stand, it is not held with a view to re-sale, and no profit has been made unless and until such land is sold The land is held as a fixed asset, all that has happened, therefore, is that there has been an increase in the estimated realizable value On no account can such an increase be treated as a revenue profit It could, however, be credited to a Capital Reserve, although it is more prudent to retain this asset at cost On the other hand, should values be going down, it is not the general custom to reduce the Balance Sheet figure, for the earning capacity of the works is not affected, and no loss will be occasioned unless a sale takes place Land therefore generally appears at cost price, and this should be stated clearly on the face of the Balance Sheet

In the case of buildings upon freehold land, depreciation should be written off—the rate will depend upon the nature of the building, its age, and condition In the case of

first class brick buildings the life is commonly taken at forty years

The cost of leasehold property must be written off to Profit and Loss Account over the period of the lease, for at the end of this period the property reverts to the lessor In the case of buildings, provision should also be made for dilapidation claims that may be made upon the expiration of the lease

As regards verification, in the case of freehold property, the auditor must inspect the title deeds and see that they appear to be in order, and refer to the particular property He should inspect the abstract of title which gives the dates and parties to the various conveyances, seeing that such conveyances are there, and that the last conveyance is into the name of his clients An auditor cannot guarantee that the title is good, all he can do is to see that the deeds are in his client's possession and appear to be in order, if in doubt on any points, he should refer to the client's solicitors

Leasehold property will be verified by an inspection of the lease, the terms of which should be noted, and the receipts for the last payment of ground rent and the premiums paid under the current fire insurance policies should be called for, in order to ascertain that these are not in arrear

If freehold or leasehold property has been mortgaged, the title deeds will be in the possession of the mortgagees or their solicitors, and, in this case, the auditor should apply direct to them for a certificate that they hold the deeds of the particular property as security for the advance, the amount of which and the date to which interest has been paid should be verified

Loans

In the case of advances upon mortgage, the mortgage and title deeds will be inspected, and it should be seen that the interest has been paid to date If, as is generally the case, a valuation of the property were made at the time of the advance, such valuation should be inspected to see that the loan appears to be sufficiently secured

With other loans, the auditor should inspect the written acknowledgment of the debt and any security that may have been lodged, such as a share certificate and blank

transfer completed by the borrower, bills of lading endorsed to the lender together with the insurance policies, endorsed dock warrants and warehouseman's certificates, together with the insurance policies, he should also see that the interest is regularly paid, and that a sufficient reserve is made for possible bad debts In the case of a company, he should see that the articles give power to make advances and inspect the directors' minute authorizing them If directors have made advances to individual members of the board or any officer of the company, the auditor must see that such loans are shown separately upon the Balance Sheet, in accordance with Section 128 of the Companies Act, 1929

Patents

The life of a patent is only sixteen years, and, therefore, the cost of acquiring it should be written off over this period If the effective life of the patent is estimated to be less than its legal life, then the cost should be written off over the period of the estimated effective life The cost of all renewal fees should be debited direct to Profit and Loss Account

The auditor should call for a list of all the patents, giving particulars of each patent, the registered number, dates, etc , and he should inspect the patent itself, and the receipt for the last renewal fee, to see that it has been paid to date

Copyrights

A copyright lasts for the lifetime of the author, and for a period of fifty years after his death There are exceptions to this, and after the author has been dead for twenty-five years, his work may be reproduced on certain terms which are prescribed in the Copyright Act The cost of publication cannot, however, be written off over the whole of this period, as in the majority of cases the value expires long before the end of the full period The only practical method therefore, is for the copyrights to be re-valued each year The object should be to write the cost, in each case, off to revenue over the period of years during which this asset produces income

There is no document of title in this case, proof of first publication constituting a copyright, unless the copyright

has been purchased, in which case the auditor should inspect the assignment The auditor should carefully consider the valuations, and see that this asset appears to be taken at a fair value

Assets Abroad

The auditor should inspect the report of the local auditor and the certificates (if any) from agents holding documents of title

Goodwill

Goodwill should not appear as an asset in a Balance Sheet, except in the case of purchase, when it should appear at cost price If the price paid for goodwill has not been fixed specifically, the amount will be the difference between the total purchase price and the assets at agreed valuations, less any liabilities taken over from the vendors Goodwill must, in accordance with the Companies Act, 1929, appear in the Balance Sheet as a separate item, and should be described as being "at cost," if that is the case

Questions are often raised as to whether depreciation should be written off this asset, and although this is undoubtedly a very wise course to adopt, it cannot, in the writer's opinion, be considered to be, either from a legal or from an accountancy point of view, compulsory Goodwill is a very peculiar asset—it is inseparable from the business, and it is unlike such assets as plant and machinery, etc , in that it does not have to be renewed or replaced

The figure at which goodwill appears in a Balance Sheet does not purport to show its present value, but merely the amount that has been expended in its acquisition, or, in other words, the amount of capital that has been invested in this particular asset

The present value of the goodwill of a business must depend entirely upon the financial position at date and the present earning capacity and future prospects of the concern, and a purchaser would not be influenced in the least by the value placed upon this asset in the Balance Sheet If the profits are large and increasing, and part thereof is used to write down the value of the goodwill, its value will in reality be increasing, whereas, if the profits are small, or losses are

being incurred, there will be no surplus profits out of which to write down the goodwill, the value of which in this case would be decreasing Again, a business that is doing very badly to-day, and whose goodwill may not be worth anything like the original cost price which appears in the Balance Sheet, in the future may be converted, through new management, into a most flourishing concern, with a very valuable goodwill

Goodwill is a very intangible asset, and it is, therefore, a very sound policy to write the cost down out of available profits or reserves, and in this way ensure that the whole of the capital of the business is represented by tangible assets, but this is a matter entirely for the proprietors of the business to decide for themselves, and an auditor cannot interfere, though he may give advice if asked to do so If goodwill appears in a Balance Sheet at a substantial amount, it is commonly regarded as a weak spot and, therefore, the Balance Sheet position is greatly strengthened if this asset is written off

Goodwill represents the sum paid for anticipated future super profits, and therefore some authorities contend that the cost should be written off against the super profits earned

The auditor should see exactly how the balance upon the Goodwill Account is made up, and that it does represent the actual cost only, no improper items having been debited thereto He should see that it is separately stated in the Balance Sheet and described as being "at cost" Apart from this he is not concerned, the Balance Sheet showing clearly what is the position of affairs He cannot insist upon this asset being written down out of profits, unless, in the case of a company, the Articles specially provide to this effect, but, on the other hand, goodwill should on no account be written up

The effect of writing down goodwill out of profits is to retain in the business profits that would otherwise be available for distribution, and, in this way, the working capital of the concern is increased Exactly the same result can be arrived at by the creation of reserves, disclosed upon the Balance Sheet, and in the opinion of many this latter is the better course to adopt, as the exact position is more clearly shown in the Balance Sheet

CHAPTER VI

VALUATION AND VERIFICATION OF STOCK-IN-TRADE OR INVENTORIES

General Considerations

THE necessity for the valuation of stock-in-trade or inventories arises because almost invariably certain goods are purchased or manufactured during one accounting period and *sold* in another

The purpose of the Profit and Loss Account is to show the profit or loss arising upon the sale of goods during that accounting period If, therefore, part of the goods sold were purchased or manufactured in a preceding period, then the unsold goods in hand at the end of the first period should be charged on to the succeeding period at cost price This has the effect of cancelling out the cost of the unsold goods in the accounts for the period during which they were purchased or manufactured and charging their cost on to the period during which these goods were sold

In certain circumstances that are dealt with hereinafter, inventories are, for Balance Sheet purposes, valued below cost The effect of this is to charge to the Profit and Loss Account, for the period during which the goods were purchased or manufactured, a loss representing the difference between the cost of the goods and the lower figure at which they have been valued Any such loss written off is almost invariably an estimate, as the true profit or loss can be arrived at only when the goods are actually sold The effect, therefore, is to charge against the realized profits on the goods sold during a period an estimated loss in value of the unsold goods in hand that will, it is anticipated, be sold in a succeeding period

The Basic Principles of Valuation

An accepted basic principle is that profit should be taken to credit only when goods are sold and therefore on no account should inventories be valued, for Balance Sheet purposes, above cost On the other hand, an accepted and

wise principle is that any possible or probable losses in connexion with unsold inventories should be anticipated by writing down their values to figures at which it is estimated that such inventories will in fact be realized during succeeding periods. In arriving at the estimated realizable value, for these purposes, there should be deducted from the anticipated sale price the estimated costs of selling and distribution.

The accepted slogan of the accountancy profession is that the basis of inventory valuation should be "the lower of cost or market price."

Accountants as a body, however, do not appear to have attempted to define precisely what is meant by the expressions "Cost" and "Market Value," and it seems not only desirable but necessary that the terms to be used in enunciating basic principles for application to a problem of such importance should be free from all taint of ambiguity.

As regards cost, there are three different methods in use in connexion with the valuation of purchased goods as follows—

(*a*) To value each lot on hand at the actual price paid for the consignment of which it formed a part.

In some cases, e.g. oil held in bulk tanks, it is impossible to identify stock on hand with the various consignments purchased, so that one of the two following expedients has to be adopted.

(*b*) To assume that the quantity held in stock represents the latest purchases and to value at these prices.

(*c*) To value at the average cost during the year, i.e. the value of the opening stock plus the year's purchases.

In the case of unfinished and completely manufactured goods the accepted principle is that these goods should be valued at works cost if that cost is below the market value. But in the case of the raw material content, any one of the foregoing methods can be applied. As regards works overhead charges several alternatives are utilized.

If for example the overheads are calculated as a percentage upon direct labour, this percentage will fluctuate with the rise and fall in the volume of production and the question arises as to what percentage shall be applied. In practice the following alternatives are used—

(*a*) The percentage for the last quarter or month of the accounting year.

(*b*) The percentage actually applied at the time the goods were manufactured.

(*c*) The average percentage for the year.

(*d*) A standard percentage based upon a normal volume of production.

As regards "market value" there are two schools of thought, the first holding that "market value" represents the replacement cost, i.e. the amount that it would cost to replace by purchase or manufacture the goods held at the date of the Balance Sheet, the second holding that "market value" represents the estimated net amount that the goods would realize when sold in the form of finished products, this value being arrived at by taking the anticipated selling price and deducting therefrom any estimated allowances, plus selling and distribution charges.

Furthermore, as regards the basic principle of the lower of cost or market value, in some cases this is applied to each lot and in othes to groups of goods. For example, a rubber merchant having a stock of raw rubber might have bought his stock during the year at widely varying prices. In these circumstances some accountants would hold that each lot should be valued at the lower of cost or market value, whereas others would claim that the total cost of the whole quantity of rubber held should be compared with the total quantity valued at the market price on the date of the Balance Sheet, the lower value being adopted.

In connexion with the valuation of partly and completely manufactured goods, if at the date of the Balance Sheet the market price of the *raw material content* has fallen below the cost price, in some cases the inventory valuation is written down by the difference and in others it is not.

The Importance of Establishing Basic Principles

It will be obvious that in practice these various alternatives are bound, in many cases, to give widely different results.

When challenged with the fact that there are so many alternative bases of valuation, accountants generally answer that the basis to be adopted depends upon the circumstances of the case. This, however, is surely an evasion of the issue

Is the true reason that the profession collectively has not yet made up its mind upon these points?

Accountants cannot dictate to the business world the exact bases of inventory valuations But it is submitted that the profession should enunciate the basic principles Were this done it would be of the greatest value to industry and to practitioners in giving a lead as to what the accountancy profession considered to be the best and soundest practice At present the profession speaks with many voices upon this subject

In the writer's opinion it seems very necessary that the basic principles applicable to inventory valuation should be clearly established, so that the auditor may have reliable gauges with which to measure an inventory valuation Otherwise very difficult circumstances may arise and the auditor may be in serious doubt as to whether he can or should not accept the valuation

For example, upon a falling volume of production the overhead percentage rises, but it seems difficult to justify writing up the inventory valuation by reason of the increased percentage, which means in effect charging on to the next year part of the cost of the idle capacity of the past year The point, therefore, arises as to whether an auditor is justified in accepting such a valuation Again, if raw materials and stores in stock have been purchased at prices that will leave a satisfactory margin of profit when the manufactured goods are sold, if the replacement value of this stock at the date of the Balance Sheet is lower than cost, the question arises as to whether the auditor must insist upon this stock being written down to the lower value

The valuation of inventories directly affects the measurement of the profit or loss for an accounting period It is, therefore, a matter of vital importance that the basis of valuation shall be a correct one In the writer's opinion, the bases commonly adopted in practice are so loose and variable that in many cases they do not result in the correct measurement of the annual profits or losses of a business

The following are the basic principles that suggest themselves to the writer, although in certain directions, which will

be pointed out, they are diametrically opposed to established practice The writer's views on this subject have been endorsed by Mr S W Rowland in an article appearing in *Some Modern Business Problems* (Longmans Green & Co), page 267

Inventories may be classified under various headings, each of which has its own problems

In the case of a merchant, he generally holds goods which he resells in the same form in which they were purchased The inventories of a manufacturer, however, comprise the following—

(*a*) Consumable stores, e g coal, oil, etc
(*b*) Raw materials
(*c*) Process or partly manufactured goods
(*d*) Finished or completely manufactured goods

The Meaning of Market Value, i e Replacement Value or Net Realizable Value

In the first place it is necessary to establish what is meant by "market value" As has been stated some interpret this term as meaning the replacement cost, i e in the case of stores and raw materials what it would cost to purchase similar quantities at the market prices ruling on the day of the Balance Sheet, and in the case of Process and Finished inventories, the cost of replacement based upon the manufacturing costs ruling at the date of the Balance Sheet

On the other hand, others contend that "market value" means the net realizable value, i e the net amount that would be realized if the particular goods held were sold in the form of finished products at the prices ruling at the date of the Balance Sheet, and after allowing for the estimated allowances, selling and distribution charges

So far as the writer is able to judge, the most general and accepted practice as regards stores and raw materials is to value them at the lower of cost or replacement value On the other hand, in the case of process and finished goods it is the lower of cost or net realizable value, although the lower of cost or replacement value is also used

In the case of finished goods, however, when in an industry there has been for example heavy over-production

resulting in a price war, it is possible for the net realizable value to be below the replacement value. In such circumstances it is submitted that the replacement value could not be justified for Balance Sheet purposes, for this reason therefore a commonly accepted basis is the lowest of cost or replacement or net realizable value.

The writer is in grave doubt as to whether it can be correct to adopt these two different bases, i.e. Replacement value for certain classes of inventories and net realizable value for others. The utilization of these two bases leads, in the writer's opinion, to several important inconsistencies. It is suggested, therefore, that there should be one basic principle applicable to all classes of inventories.

It appears to the writer that the only basic principle that can be applied to all classes of inventories is the "*net realizable value*," provided, however, that this is interpreted to mean the *net realizable value of the goods in the form in which they will in fact be sold, which in the case of a manufacturer is normally in the form of the manufactured goods.* Thus in the case of stores and raw materials the bases would be, not their saleable value as stores and raw materials, but as component parts of the manufactured goods.

It is an accepted principle that the valuation of assets for Balance Sheet purposes is upon the "going concern" basis. It is submitted, therefore, that in the case of a manufacturer, all classes of the inventory, i.e. stores, raw materials, process and finished goods, represent merely stages in the process of manufacture, and all are held with a view to the production and sale of *the finished products* in which the particular concern deals. In the case of a tyre manufacturer, for example, rubber and cotton are held with a view to conversion into and sale as tyres and as a rule only in the event of liquidation would the rubber and cotton be sold in their crude form. It is submitted, therefore, that it is *the net realizable value of the finished product* that should be measured against the cost value of *all classes* of inventories in assessing the Balance Sheet valuations.

The Meaning of Cost

As regards the various alternative means by which cost is arrived at and which have been dealt with already, it is

suggested that here again it would be most helpful if the profession were to agree upon basic principles

In the case of the purchased goods of a merchant and the stores and raw materials held by a manufacturer, at first sight the actual cost of the individual lots would appear to be the most logical basis to adopt In this case, however, if during the year purchase prices had fluctuated between wide limits, a manipulation of the accounts could be effected, for example, by deliberately drawing during the year from all the low priced lots or vice versa

The writer would suggest that the fairest basis to establish cost is the year's average, calculated by taking the value of each class of the inventory, e g raw materials and stores, at the commencement of the year, adding thereto the cost of the total of each class of purchases during the year and dividing by the total quantities involved

If this method were found impracticable, then it is suggested that cost should be established upon the basis of the latest invoice prices, working the invoice quantities back over the quantities held in stock at the date of the Balance Sheet

The cost figure would in all cases be increased by any direct expenses such as freight, duty, landing, dock and reasonable warehouse charges, etc , and on the other hand all trade discounts and allowances should be deducted

In the case of process and finished inventories, it is suggested that standard cost is the sound basis to adopt This standard cost would be based upon the current cost of raw materials and direct labour plus overheads based upon a normal volume of production (say 75 per cent to 80 per cent of full capacity)

This is not accepted practice, but if the current overhead rates are used, then the valuation of the inventory is directly affected by the volume of production If, therefore, a year with a high volume of production is followed by one with a low volume, and if the cost of materials and labour is the same in both years, then a given unit of stock will be valued at a higher price at the end of the year than it was at the commencement In such circumstances it is commonly argued that the valuation in each case does represent cost, but the true reason for the high valuation at the end of the

year is the low volume of production, which has increased the works overhead percentage This means that there has been loaded on to the inventory an abnormally high percentage of overhead charges, with the result that part of the cost of the idle capacity of the past year is being carried forward to the succeeding year The reverse would be the effect in a year with a high volume of production following one with a low volume In that event a low inventory valuation would result with corresponding benefit to the succeeding year

By adopting a standard cost valuation, the value of any unit of stock would be the same at the beginning and end of the year, unless the standard costs had been varied as they naturally would be from time to time if changes took place either in the costs of raw materials, in direct labour, or in production methods Under this basis of valuation each year would bear the full cost of idle capacity, which it is submitted it correctly should do

In the writer's opinion, the cost of idle capacity should be segregated to a separate account in the financial books, and should not be included in costs or in inventory valuation For this purpose, by idle capacity is meant the cost of factory space, plant and equipment that have not been utilized at all during an accounting period

Fluctuations in the percentage of overheads included in inventory valuations from year to year can be avoided to a material extent by establishing the practice of excluding, for the purposes of inventory valuation, all fixed overheads, i e those that do not fluctuate with the volume of production, such as rent, rates, insurance, depreciation (if fixed annual amounts are written off), management salaries, etc

The Valuation of Different Classes of Inventory

Based upon the principle of the lower of cost or net realizable value as described above, the various classes of inventory would be valued as follows—

STORES Stores are held for use and not for sale in their crude form For example, coal represents an essential element in the production of the power required for manufacturing purposes

It is submitted, therefore, that the Production Account

for each accounting period should bear the actual cost of the coal used, regardless of the period when the coal was purchased Stocks of coal, therefore, would be valued at cost, i e the year's average or at the latest invoice prices

If there has been a fall in the replacement cost of stores as between the date when they were purchased and the Balance Sheet date, this does not necessarily mean that a loss arises but merely that these stores could have been purchased cheaper if the placing of the contracts had been delayed But inventory levels require to be kept in relationship with the volume of production, and the purchasing department has yet to be found that can invariably buy at the bottom of the market

If in the above circumstances, these stores are written down to the replacement cost, as is the common practice, an artificial loss is added to the cost of stores for the past year and the cost of stores for the coming year is artificially reduced by a corresponding amount Provided that the production costs of the goods manufactured continue to show a satisfactory margin of profit, it is submitted that the valuation of stores *at cost* is fully justified and could not be contested by an auditor

This basis is in accord with the suggested principle of the lower of cost or net realizable value, as if there is a margin of profit upon the sale of *the finished product*, a profit will be realized when the stores are sold in the form of manufactured products

SPARE PARTS Stocks of spare parts in the main will be used in connexion with the maintenance of plant and equipment When used, therefore, the cost of these spare parts become revenue expenditure In some factories items of plant are manufactured in the factory's own machine shops, in which case spare parts from stock used in the manufacture of equipment become part of the fixed assets and therefore become capital expenditure

It is submitted that the basis of charge in both cases should be cost Therefore spare parts in stock should be valued at cost and need not necessarily be written down to replacement value if that value is lower at the date of the Balance Sheet

It is not uncommon to find complete items of equipment

held in reserve in case of breakdown It is suggested in this case that such items should not be included in stock, but when purchased should be charged at cost direct to the appropriate fixed asset account

SCRAP Stock of scrap, including discarded equipment, it is submitted, should be valued for inventory purposes at its net sales value as scrap

RAW MATERIALS Here again the common practice is to value at the lower of cost or replacement value

In the writer's opinion, however, the basic principle should be the lower of cost or the net realizable value in the form of the finished products

If raw materials are purchased in one period and used in a succeeding one, they should, it is submitted, normally be charged on at cost, so that each period may show the true margin of profit

If at the date of the Balance Sheet the replacement value is below cost no loss has arisen, or is likely to arise, provided that there will be a margin of profit upon the ultimate sale of the finished products In the case of patented and proprietary articles and with many others there is frequently an ample margin of profit on the selling prices of the products and in many cases short term selling prices are not directly affected by fluctuations in the prices of the raw materials used In such circumstances, it is submitted that cost is the correct basis of valuation in accordance with the suggested basic principle

If, however, at the date of the Balance Sheet the selling prices of the finished products have fallen, it is necessary to ascertain whether or not—after taking into account all manufacturing, selling and distribution expenses—a margin of profit remains if raw materials are included at cost If not, then the raw material inventory should be written down In such circumstances, practical difficulties are likely to arise in calculating the amount of depreciation to be written off

In the case of a manufacturer producing a variety of articles, as a rule, there will not be for each line the same relationship of works cost to net sales value, and at the date of the Balance Sheet it is impossible to estimate the exact

quantities of the various lines that will be produced from the raw materials on hand

If, therefore, at the date of the Balance Sheet, there has been a heavy fall in selling prices due, for example, to a price war, then obviously a serious position has arisen and it is submitted that the inventory valuation requires exhaustive consideration

In accordance with orthodox practice, raw materials would be valued at the lower of cost or replacement value, but, in the foregoing circumstances, taking raw materials at this value, production costs might still exceed the net realizable values of the finished goods. Therefore, upon this basis, if the low selling prices of the finished products persisted, then the coming year would be involved in a loss upon the sale of the goods manufactured from the raw materials on hand

It is submitted, therefore, that in the case of raw materials, as with the other classes of inventory, the crucial factor is the net realizable value of the finished products In the event, therefore, of low and unprofitable selling prices prevailing it is suggested that the whole of the facts require most careful and exhaustive investigation, and the raw material inventory should be written down to such a level that, as nearly as can be estimated, no loss will be incurred in the succeeding year upon the sale of the corresponding finished products

Quite apart from theoretical principles it is obvious that, if selling prices are at an uneconomic level, then a dangerous situation has developed and therefore that it is financially prudent to adopt the most conservative basis of inventory valuation In such circumstances the valuation is largely a matter of judgment

A very conservative valuation is arrived at under what is known as the Base Stock Method Under this method a fixed base price is established, this base price being a low one and well below the long term market average The raw material stocks are valued each year at the base price regardless of their cost Under normal conditions the inventory valuation is therefore below both cost and replacement value From the point of view of conservative finance this method has supporters, but it certainly distorts the true measurement of annual income

FORWARD CONTRACTS FOR THE SUPPLY OF RAW MATERIALS It is common practice for manufacturers to place forward contracts in order to ensure supplies of raw materials, and if, in such circumstances, the replacement price of such materials at the date of the Balance Sheet is below the contract price, the question arises whether any provision should be made therefor in the accounts for the past year Practice differs Some companies invariably provide for such differences at the date of the Balance Sheet and others do not In cases where the forward contracts for raw materials have been placed to cover sales contracts that have been fixed, and upon which, taking the raw materials at the contract prices, a margin of profit will be shown, there does not appear to be any reason, except cautious finance, why provision should be made in the preceding year's accounts for the fall in the price of the raw materials The raw material contracts in these cases have been placed in order to ensure the margin of profit upon the forward contracts for the sale of the manufactured products In cases where such forward contracts have been placed but are not in respect of specific sales contracts, it is no doubt a conservative financial policy to write down, in the case of a fall in the market price, but in the writer's opinion it cannot be said that it is essential for the same reasons as have been given above in connexion with stocks of raw materials But here again, if there had been a severe fall in the price of the raw materials with a corresponding fall in sale prices of the manufactured articles so that at the contract prices of the raw materials it will be impossible to manufacture at a profit, then undoubtedly provision should be made so that in effect these raw materials are written down to a price at which the coming year can manufacture and sell without loss

It is submitted that the same basic principle applies, namely that the governing factor is the net realizable value of the finished products that will be manufactured from these raw materials Nevertheless, circumstances may be encountered which require special consideration

A manufacturer, for example, under the impression that his raw material market is likely to harden against him in the near future, buys heavily and finds himself at the close

of his financial year with raw material stocks and forward contracts sufficient to cover his normal production for one and a half years as against the usual three to four months requirements which experience has hitherto proved expedient At the date of the Balance Sheet it appears that his estimate of the market movements has been completely wrong For the market value of these raw materials has dropped and appears likely to fall much farther At the date of the Balance Sheet the selling prices of the finished products have not yet been affected by the fall in the price of the raw material, and there is therefore a margin of profit on the basis of the actual cost of the raw material

In these circumstances, obviously a very serious situation has arisen Owing to the departure from the normal buying policy, and the holding of an abnormally large stock of raw materials, together with the heavy forward contracts, exposes an abnormally large area of vulnerability in that it is impossible to prognosticate what the selling conditions of the finished products will be a year and a half ahead A comparatively long time, therefore, must elapse before either the wisdom or imprudence of the policy of heavy buying of raw materials is capable of demonstration, and considerable risks are involved

It might be considered satisfactory to value the raw material stocks and the forward contracts on the basis of the replacement price at the date of the Balance Sheet But in the circumstances described above where there is one and a half years cover it is impossible to estimate the selling prices of the finished product, and there is the risk that raw material and selling prices may fall considerably lower Therefore the valuation of the raw material stocks, and the treatment of the forward contracts becomes, it is submitted, a matter of judgment In such circumstances, upon the principle of sound financial policy, and after weighing up all the circumstances of the case, drastic treatment may well prove to be the wise course

This, it is submitted, in no wise impairs the validity of the basic principles which have here been advocated, for it will be appreciated that as the circumstances postulated are quite exceptional to the business, they require special treatment in the accounts

The *Pepper Pool* case, reported in *The Accountant*, Vol XCIV, pages 305 and 323, is of considerable interest in connexion with the subject of forward contracts generally

The circumstances were that a pool was formed with the object of "cornering" the pepper market Large forward purchases were made and in consequence the market price of pepper rose considerably These high prices unexpectedly resulted in large quantities of pepper coming on the market far in excess of the pool's anticipations In order to maintain the market price the pool was therefore forced to extend its purchases far in excess of its original plans, and in consequence financial embarrassments arose which eventually brought about disaster

Shortly prior to this a prospectus was issued in respect of the old established business of James & Shakespeare Ltd This company was controlled by some of the accused, and the company was heavily involved in these forward commitments in pepper The cash received under the issue was used to finance part of the pepper commitments

In the prospectus no mention was made of the considerable forward contracts Produce merchants in the ordinary course of business have reasonable forward commitments But in this case the amounts involved were so considerable that it was clear that these transactions could not be regarded as in the ordinary course of normal business Obviously a highly speculative position existed, but there was nothing to indicate this fact in the prospectus

Bishirgian, who was a director of James & Shakespeare Ltd, was found guilty of issuing a prospectus knowing it to be false in a material particular, and Howeson and Hardy were found guilty of aiding and abetting him They were all sentenced to imprisonment in the second division

This case is worthy of close study by the professional accountant both from the point of view of certificates of profits for prospectus purposes, and also as regards the audit of business accounts In both cases it is clear that, if there is evidence of forward contracts, the accountant should carefully examine the whole position If the total amount of these contracts is normal, they are in the ordinary course of business, and there is nothing to indicate losses upon them, then there would appear to be no reason why

special mention of these forward contracts should be made in a prospectus or in the Balance Sheet of a company But, if the amounts involved are abnormal and obviously a speculative situation exists that may result in serious losses, then the lesson to be learned from this case is that these facts should be made clear in a prospectus and also, it is submitted, in a Balance Sheet In either case, if an auditor is aware of these facts, he should insist upon the position being made clear

PROCESS OR PARTLY MANUFACTURED GOODS

In the case of Process and also finished goods, as has been stated, it is thought that the most generally accepted principle is the lower of cost or net realizable value, however, some authorities contend that the basis should be the lowest of cost or replacement or net realizable value

Following the principles enunciated above it is suggested that process stocks should be valued at current standard cost, or the net realizable value in the form of finished products, whichever is the lower

It will be appreciated that there is no question of anticipating profit by the adoption of this principle, as the net realizable value is only adopted *if it is below cost*, and therefore there cannot be any profit in the valuation

It is submitted that the process stocks should be taken as a whole and valued at current standard cost and also at the net realizable value, i e the sale price of the finished product, less allowances, costs of selling, distribution and cost of completion of manufacture If in total the net realizable value is below the standard cost value, then the lower valuation should be adopted

The standard cost would cover raw materials, direct labour and normal works overhead applicable to the partly manufactured goods No addition should be made for selling, distribution, administration and financial charges

In the case of the raw material content of unfinished and completely manufactured goods, the common practice is to include this at cost The basis of valuation, however, in some cases is the lower of the cost of the raw material content or the replacement value at the date of the Balance Sheet Here again no settled practice exists, and although the writing down of the stock in this way is undoubtedly a prudent policy, it cannot be said to be essential provided

always that the total value of each class of stock does not exceed the net realizable value in the form of finished products

FINISHED OR COMPLETELY MANUFACTURED GOODS It is submitted that exactly the same principles should be applied as in the case of the process stocks of a manufacturer, except that with finished goods the net realizable value will be represented by the sale price less allowances, costs of selling and distribution Here again no question of anticipating profit is involved in the adoption of this basis of valuation

In the case of a merchant the basis will be the lower of cost or net realizable value

DAMAGED AND OBSOLETE GOODS In the case of all classes of the inventory all damaged and obsolete goods should be written down to the amount it is estimated that these goods will realize when sold in the form that it will be possible to dispose of them, in some cases this will be in the form of second grade products and in others in the form of scrap Here again allowance must be made for the costs of selling and distribution

UNSOLD PRODUCE, ETC In the case of tea, coffee and rubber estates, tin dredging and mining undertakings, it is a common practice to value the unsold production at the date of the Balance Sheet at the net amount subsequently realized The object of this practice is to credit each year with the total amount realized upon the sale of the production of that year In such cases, where at the time the accounts are being completed the whole of the unsold production has in fact been sold, there can be no objection to this practice The auditor should inspect the account sales or other similar evidence, verifying the sales of the stock during the subsequent period, and this stock should be described in the Balance Sheet as "at net amount subsequently realized," an example can be seen in the Balance Sheet of Dunlop Plantations, Ltd, in Appendix A In this way it is made clear that the profit has been put back into the year during which such stock was produced It will be appreciated, however, that this practice is a distinct departure from the ordinarily accepted principles of inventory valuation It is, however, the established practice in the case of undertakings of the type referred to

Policy Considerations and the Importance of a Consistent Basis

Considerations of financial policy commonly result in the adoption of a conservative basis of inventory valuation and this course is obviously a prudent one But policy is quite apart from the question of the basic principles that should govern inventory valuations, and the auditor is not concerned with policy

It is, however, most important that a consistent basis shall be adopted from year to year, as otherwise the trading results shown by the accounts become distorted It is very necessary, therefore, that the auditor should verify that the same basis is adopted each year If the basis has been changed and the change materially affects the results, then it is submitted that this fact should be made clear either in the accounts, the Directors' Report, or in the Auditor's Report

The Auditor's Duties as Regards Inventories or Stock-in-trade

The auditor's position as regards inventories is one of very great difficulty, for the amounts involved often are very considerable and materially affect both the Profit and Loss Account and the Balance Sheet, and falsification of accounts is frequently effected by means of stock manipulations But it is impracticable for the auditor himself to take, inspect, or value the stock, and unless stock books have been kept, the books of account do not disclose what stock should be in hand at the date of the Balance Sheet Further, there is no certain means by which he can verify the existence of this asset, such as are available in the case of cash in hand, bank balances, investments, freehold and leasehold properties, etc In fact, the auditor has less control over this asset than he has practically over any of the other assets of a business, and he is bound to rely very largely upon the internal checks in this connexion, and upon the certificates given by the management—in fact, the stock presents one of an auditor's greatest difficulties

The principal errors that have to be guarded against, all of which may be purposely or unintentionally committed are as follows—

(a) Incorrect additions and calculations

(b) Incorrect prices and valuations

(c) The inclusion of goods in stock, the invoices for which have not been passed through the purchases

(d) The inclusion of goods in stock that have already been sold and entered as sales, prior to the date of the Balance Sheet

(e) The omission of stock in the hands of agents, at docks, in warehouses, etc

(f) The inclusion of plant, tools, furniture, etc , in stock, which have already been debited to an asset account

(g) The omission to provide for depreciation in the case of damaged, out of fashion, or obsolete stock

(h) The valuation of stock upon the basis of incorrect principles

If proper stock accounts have been kept, these will be of great assistance to the auditor for the purpose of checking the stock, and any large differences between the quantities shown by the stock books and the stock sheets should be most carefully investigated

Before commencing the actual checking, the auditor should carefully inquire into the whole system of taking, entering, pricing and checking stock, and find out the exact basis upon which it has been valued As stated above it is very important to ascertain that the basis of valuation at the beginning and end of the year is consistent As many persons as possible should be engaged upon the stocktaking, and each step should be independently checked Further, responsible officials should supervise the work, as juniors often have quite erroneous ideas concerning what is rightly included in stock, and the principles governing its valuation Each person who takes part in the stocktaking should initial the sheets he has entered up or checked, and a responsible official, such as a managing director or partner, should give an over-riding certificate to the effect that the stock has been correctly taken, is valued upon a consistent basis, that the basis of valuation in all cases is the lower of cost or net realizable value, and that the total valuation of the stock represents, in his opinion, a fair and proper valuation of this asset

In the case of a manufacturing business, the auditor

should make most careful inquiries as to the valuation of the process and finished stocks, and as to the whole system for dealing with this, in many cases, most complicated matter. In some factories, goods may pass through twenty or more distinct stages of manufacture before they are completed, and in each stage, wages, materials and expenses are being expended. Therefore, it will be appreciated that at the date of the Balance Sheet, in the ordinary course, there will be goods at every stage, and that the cost in each stage will be different. Unless proper cost accounts have been kept, it is practically impossible correctly and accurately to value partly manufactured stocks, as the only means of checking that an auditor has is the comparison of the stock valuations with the cost records, which records should show the exact cost of each stage in the process of manufacture. In any event, the auditor is necessarily to a considerable extent in the hands of the management, as there are practically no independent checks possible, except cost records, and the comparison of the percentages shown by the accounts of other years; and even these latter are not conclusive, and may only lead the auditor to the general conclusion that the stock valuations appear to be unsatisfactory.

Having inquired into the whole system of stocktaking, the bases of the valuations and the internal checks, the auditor should check and test the stock sheets as far as possible, and the lines upon which he should carry his investigations should be as follows—

(*a*) Check the castings, or a fair portion thereof, bearing in mind that there is no double-entry check upon these totals.

(*b*) Check a proportion of the calculations, selecting mainly the larger items, but bearing in mind that items calculated as singles may in fact be dozens or gross.

(*c*) Compare the stock sheets with those of the previous year, especially as regards prices and quantities, making careful inquiries if important fluctuations occur, and also with a view to ascertaining whether any part of the stock has been in hand for long periods, and may thus be out of date or obsolete.

(*d*) In the case of raw materials, stores and purchased goods, the orthodox practice is to compare prices with recent

invoice and market prices For the reasons already given in the writer's opinion all classes of stock should be measured against their net realizable value in the form of finished products

(*e*) Examine the Goods Inwards Book for the last few weeks of the period, and trace any large items into stock and into the Bought Day Book

(*f*) Trace any large sales towards the end of the period into the Goods Outwards Book, and see that these goods have not been included in stock

(*g*) In the case of partly and completely manufactured goods, test these with the cost records, and ascertain the basis upon which the additions for overhead charges have been calculated If there are no Cost Books, see that full particulars are given as to how the figures are arrived at, and that these are certified by a prominent official Test these items as far as possible with any available evidence

(*h*) If Stock Books are kept, check the quantities with the Stock Book balances, carefully inquiring into any important differences

(*j*) In some businesses the quantities in stock can be checked easily, as, for example, in the case of a coal merchant the Bought and Sales Day Books should be ruled with quantity columns, and thus the total tonnage sold during the period, deducted from the tonnage in stock at the commencement, plus the tonnage purchased, should give the quantity in stock at the end of the period There will be always small differences owing to waste Normally such differences should not vary much in percentage

(*k*) Inquiry should be made as to whether there are any goods in the hands of agents, at the docks, or warehouse, etc , that may have been omitted from the stock sheets Quantity stock certificates in these cases are usually obtainable

(*l*) When examining the stock sheets it should be seen that no plant, tools, furniture, etc , are included

(*m*) When the Trading Account is completed, the auditor should compare the percentage of gross profit to sales with that of previous years, and if there are any marked fluctuations, inquire into the reasons Such fluctuations in the percentages may be due to variations in volume or in prices

of sales or purchases, or rates of wages, to exceptional contracts, or to improved production, but if the auditor is not satisfied that the fluctuation is caused by one or other of these circumstances, it must be that the opening or closing stock is incorrect, or that the opening and closing stocks have been valued upon a different basis This percentage test is of very great value, but it cannot be applied in all cases, as in some businesses there is no constant percentage of gross profit which on the individual transactions may vary considerably

(*n*) Verify that the basis of the valuation of the whole of the stock is consistent with that adopted in previous years

The foregoing are tests that may be applied to the stock-in-trade, but an auditor can never be absolutely certain that this item is correct, and he is bound to depend to a considerable extent upon the certificate of the management But he must exercise reasonable care and skill in order to satisfy himself that the stock has been correctly taken and valued, and, therefore, he must make exhaustive inquiries and test the stock sheets as far as he can in the circumstances of the particular case, and if he is not completely satisfied he should, without fail, deal with the matter in his audit report

The legal responsibility of auditors as regards stock-in-trade is a question of considerable importance, and is dealt with later in Chapter XI In the meantime, it should not be thought that it is suggested that an auditor *must* apply all the above tests in every case, but that, realizing what an important bearing the valuation of stock has upon the accounts, how easy it is to falsify the accounts through the stock, and how difficult it is for the auditor to verify this item, it is most advisable that an auditor should pay particular attention to this asset, and endeavour to verify it as far as he possibly can within reason, and that he should not rest content with mere compliance with what may appear to be the strict legal requirements in this direction

CHAPTER VII

DEPRECIATION, RESERVES AND SINKING FUNDS

General Consideration of Depreciations

THE subject of depreciation is one of the very important and at the same time difficult matters with which an auditor has to deal, therefore it is proposed to discuss the principal points that must be borne in mind by an auditor But it is impossible in the space available to deal completely with the whole of this subject, and all accountant students are strongly advised to study it exhaustively in all its bearings, for considerably more attention is being paid to this question by the industrial world than has been the case in the past—therefore, every auditor should be well versed in all the governing principles

Two valuable papers on "Depreciation and Obsolescence" were delivered at the International Congress on Accounting held in 1933, one by Sir Harold Howitt and the other by Mr A S Fedde, of New York These papers and the subsequent discussions appear in the published proceedings of the Congress, and also in *The Accountant*, Vol LXXXIX, pages 505 and 541 Both of these papers and the discussions on them are worthy of close study as they represent the modern British and American views upon this important subject It will be seen, however, that divergent views are held by accountants as to the methods to be adopted for writing off depreciation in accounts, and the student may well be troubled in deciding which course to adopt

In practice, the term "depreciation" is commonly used in a very wide sense, covering decreases in the values of assets caused by outside fluctuations in replacement values, and also the amortization of the cost of an asset over the period of its use

Fluctuations in the Market Value of Fixed Assets

Fluctuations in the replacement or realizable values of fixed assets are not as a rule provided for when preparing the accounts of a business for these fluctuations are caused

by outside factors in no way affecting either the earning capacity or the actual revenue earnings of such assets For example, in the case of land upon which a factory is built, the market fluctuations in the value of such land are properly disregarded, for this asset is not in the market for sale, but is held merely for the purpose of providing the space upon which to erect the buildings necessary for the purposes of the business The trading results of the concern, and the earning capacity of this asset are, therefore, in no way affected by such outside fluctuations in value Consequently, an asset of this nature appears in the Balance Sheet "at cost," so that in this way is shown how much of the original capital was sunk in the acquisition of this property

If fixed assets, such as investments, are held, and it is anticipated that they may be sold in course of time, then, if market values appear to have fallen permanently, and therefore, it appears that losses upon realization will be incurred, it is wise to hold back part of the profits and thus provide a reserve against this contingency, and thus ensure that the original capital sunk in the investments is kept intact

The writing down of the value of investments in these circumstances is purely a matter of financial policy and upon which the auditor could not insist If, however, the auditor were dissatisfied with the valuation of this asset and its description in the Balance Sheet, he can, of course, qualify his report to the shareholders, and he should do so if, in his opinion, a misleading picture is being presented

Depreciation of Wasting Assets

The depreciation that must be provided for, if accurate accounts are to be prepared, is the shrinkage in value of assets that is caused by, and is the result of, using such assets for the purpose of earning revenue In this case the shrinkage in value is the natural and inevitable result of employing the asset for the purpose of earning revenue For example, in the case of plant and machinery, manufacturing therewith necessarily has the effect of gradually wearing out the machines Such depreciation does affect

the earning capacity of the asset, and the correct trading profits are not ascertained unless a proper charge is made for the cost of the machinery used. Therefore, depreciation should be provided for in the case of all wasting assets, that is, assets that are used up or exhausted in the course of seeking to earn income, examples being buildings, plant and machinery, furniture and fixtures, horses, carts, vans and harness, leases, patents, copyrights, etc.

The Main Object of Providing for Depreciation

The main object of providing for the depreciation of wasting assets is to keep the original capital intact. As part of the capital of the concern has been invested in the purchase of these assets, which have a working life of only a limited period, therefore, when this working life comes to an end, and the earning capacity of these assets ceases, they will become valueless for the purposes of the business, and the original capital sunk in their acquisition, less any scrap value of the assets, will have been lost. Hence, in order to keep the capital of a business intact, if any part thereof is invested in the purchase of wasting assets, revenue must be held back by means of depreciation charges to Profit and Loss Account, in order to replace the capital that is being lost by reason of the fact that it is represented by assets that are being consumed or exhausted in the course of trading or seeking to earn income. For example, in the case of a factory, in order to produce the finished goods that are sold, it is necessary to use raw materials, labour *and machinery*, and the cost of the machinery is just as much a charge against the revenue earned as is the cost of the materials and wages. If to manufacture certain goods one machine alone were necessary, and that machine were purchased at the commencement of the financial year of the business, assuming the working life of this machine to be one year only, then, in this case, when calculating the profit or loss upon the goods manufactured, against the sales there would have to be charged the cost of production, which would be the cost of the materials used, the wages, expenses, and the cost of the machine which had been used up in the course of manufacture. The cost of the machine is just as much

part of the cost of producing the finished goods as the materials and wages, for in order to convert the raw materials into the saleable articles, both the machine and the labour and materials are necessary In this way, out of the amount realized upon the sale of the goods, there is held back the cost of the machine, and thus the capital sunk in its purchase is replaced, whereas, if this were not done, the effect would be that a loss of capital, directly caused by the manufacture, would not have been provided for, and the available capital of the business would be permanently reduced thereby, the result being just as wrong in principle as if the cost of the labour had not been charged The foregoing is, of course, a very simple case, but exactly the same principles apply where the machinery lasts for a period of years, in this case as the plant will continue to be used for a number of years, its cost has to be spread over this period In this way, during the life of the machinery, out of the revenue earned thereby, there will be held back the original cost thereof, and thus the capital invested in this wasting asset will be replaced, such capital being available for the replacement of the worn-out asset, or for the general purposes of the business

In all cases, therefore, where one of the direct causes of earning revenue is gradually to consume fixed assets of a wasting nature, the depreciation of such assets should be provided for out of revenue For the cost of such assets is, in fact, a direct revenue charge, but it is one that, in most cases, has to be spread over a period of years, as the benefits arising therefrom are not all exhausted in the one year, as is the case with the majority of revenue charges, such as rent, rates, taxes, salaries, etc

Replacement Cost

In recent years arguments have been put forward to the effect that depreciation should not be calculated upon the original cost of an asset but upon the estimated cost of replacement These views originally arose owing to the great increase in replacement costs which occurred during and after the War, and are founded upon the principle that the object of depreciation is to provide for the cost of

replacement In the author's opinion this principle is incorrect, and the correct one is that the object of depreciation is the replacement of the original capital investment An increase in replacement costs is an important matter and means that additional capital is required in order to maintain the original earning capacity In these circumstances with a view to providing the additional capital necessary, it is suggested that, purely as a matter of financial policy, appropriations should be made out of available profits to a special or general reserve

Obsolescence and Effluxion of Time

Other factors which have the effect of exhausting the value of assets are obsolescence and effluxion of time Obsolescence, in the case of plant, means that new and improved machinery has been invented, which will manufacture better, cheaper, or in greater quantities, and, therefore, if these new machines are widely adopted in the particular trade, the old plant must be "scrapped" and the new machines installed, as otherwise the particular business will not be able to compete successfully with its rivals, and thus keep its place in the particular industry Therefore, in fixing the working life, this eventuality should be considered, and the period fixed should be the period during which it is estimated that the machinery will be suitable for the purposes of the particular business, and will be able to manufacture the required standard of articles in sufficient quantities, and at a cost that will enable the business to meet competition The practical difficulty is that it is impossible to forecast when obsolescence will arise It is submitted, therefore, that the better course is to deal with this contingency separately from the normal provision for depreciation by means of appropriations of profits to a special obsolescence reserve The great value of such reserves is being appreciated by industry to-day

Dealing with this question in an article, *The Accountant* (Vol XCVIII, page 652) stated—

Obsolescence will ever remain, we fear, a problem not amenable to easy solution We have always thought it important to remember, in this connextion, that the financial aspects of the problem are more

important than the purely accounting aspects, that is to say, the real difficulty confronting the business man is to be sure that his liquid position is so strong that he can afford to be ruthless should business conditions demand the rejuvenation of his plant This consideration seems to us to point to the advisability of regarding obsolescence as an appropriation from the profit of favourable years through the building up of reserves of profits available for the scrapping of plant as and when competitive conditions render that advantageous It is, of course, true that this practice does not run parallel with income tax procedure and involves the payment of tax followed by a later allowance which may, or may not, correspond, but we do not think that the precise manner in which the incidence of income tax falls on successive financial periods ought to weigh unduly in the formulation of financial policy

Effluxion of time is a factor in such cases as leases, where at the end of a fixed period the lease terminates, and all value, therefore, ceases The amount paid for a lease is, in effect, the capitalized value of rent paid in advance, and must, therefore, be written off to revenue over the period of the lease, as also must the cost of any buildings erected upon leasehold land, and any improvements effected by the lessor

Estimation of the Working Life of Plant and Machinery

The difficulty in dealing with the question of depreciation of such assets as plant and machinery is that the working life has to be estimated, and there is no certain way of arriving at this period, therefore, past experience and expert and technical knowledge are required when dealing with this point In practice, it is only too commonly found that the cost of all the plant and machinery is included in one account, in which case it is impossible to estimate the depreciation accurately, for the lives of all the various classes of machinery, etc, included under the one head will be very different, for example, boilers and such like heavy plant may last for a number of years, but fast-running machines may have a very short life only, and such accessories as belting will have to be renewed constantly In the above circumstances, therefore, the fixing of the depreciation is a mere matter of guess-work, the accuracy of which can only be proved or disproved in the light of after years If, then, as is very probable, it is found subsequently that the depreciation has been under-

estimated, the evil will have been done, in that past profits will have been overstated, and if, furthermore, such profits have been distributed to the proprietors of the business, part of the capital of the concern will have been lost Such circumstances have in many cases been the chief cause of bankruptcy, as it has been found impossible to replace the capital that has been lost owing to the inadequate provision for depreciation

Plant Register

In the writer's opinion the only satisfactory method for dealing with the depreciation of plant and machinery is to keep a special "Plant Register," in which a record is kept of each machine The whole of the plant and machinery should be split up into classes, so that only items with approximately equal working lives would be grouped together Full particulars should be entered in connexion with each machine, and a special column should be provided in which should be entered the cost The "scrap value" and the working life of each should be estimated and entered in the register, and a number of columns should be provided for the annual amounts written off for depreciation, which, in the writer's opinion, should be an equal amount each year, so that the cost less the "scrap value" is written off over the estimated period of the assets' working life upon the straight line system In the light of actual experience, these estimates should be constantly revised, so that as far as possible accuracy is attained At the end of each financial period, summaries should be prepared from the registers showing in totals, as regards each class of machinery, the opening balance, the additions, the total depreciation written off, sales and the profits and losses thereon, and the closing balance The Plant and Machinery Accounts in the General Ledger should be adjusted to agree with such summaries Upon the sale of a machine, the amount realized should be credited in the register, and any debit balance written off as a loss upon sale

The foregoing method may appear to be unduly complicated, but once the register has been written up, it will be necessary only to keep it up to date, and this will not entail a great amount of labour On the other hand, it

will be possible to deal with the question of depreciation, which so vitally affects the accounts, with a degree of accuracy which otherwise is quite impossible, and, further, most valuable practical information as regards the various machines will be accumulated, which will be of very great assistance to the management

Cost of Maintenance and Maintenance Reserves

The cost of maintenance, such as repairs and renewals of parts, should be charged direct to revenue, and if these charges vary considerably from year to year, it is a good plan to create a Maintenance Reserve Account, so that the annual charge to revenue may not fluctuate To effect this, the average annual charge under this head over a long period of years should be arrived at, or, if such material is not available, expert advice should be sought, and this average amount should be debited each year to Profit and Loss Account, and credited to the Maintenance Reserve Account As the repairs take place, the cost thereof should be charged direct to the Maintenance Reserve Account, and if the estimate has been correct, the credit balance upon this account should be sufficient to provide for these annual charges The credit balance upon the Maintenance Reserve Account should be carried forward as a separate item upon the Balance Sheet If this account shows a debit balance, this would mean that the annual provisions have not been sufficient, and, therefore, such debit balance should be written off to Profit and Loss Account, and this question reconsidered, and the annual provision accordingly increased It may be, however, that in the first few years, before the reserve has had time to accumulate, the actual charges may outweigh the credits, and, in such circumstances, if it is reasonably certain that the credits in the next few years will bring the account into credit, a debit balance might be carried forward, but, in this case, this item would have to be separately stated and clearly described in the Balance Sheet However, as a general rule, and except in very exceptional circumstances, a debit balance should never be allowed to be carried forward upon a Maintenance Reserve Account

Methods for Writing Off Depreciation

The various methods used in practice for writing off depreciation are as follows—

FIXED INSTALMENT OR STRAIGHT LINE SYSTEM Under this system a fixed percentage, *calculated upon the original cost price of the asset*, is written off each year, for example, in the case of an asset costing £1000, the working life of which is estimated to be ten years, ignoring the residual value, the depreciation charge each year would be 10 per cent on £1000, that is £100 per annum Under this method it is necessary to make a separate calculation in respect of all additions, but if a Plant Register is kept, as suggested above, it can easily be adopted, and, in the opinion of the author, it is the most effective and accurate method of calculation in respect of industrial plant and equipment

REDUCING INSTALMENT SYSTEM Under this system a fixed percentage is written off each year, *calculated upon the reducing balance brought down upon the asset account* That is, if 10 per cent is being written off an asset costing £1000, the depreciation written off in the first year will be 10 per cent on £1000, that is, £100, in the second year it will be 10 per cent on £900 = £90, and in the third year 10 per cent on £810 = £81, and so on It will be seen that the amount written off becomes less each year, and the orthodox argument is that, in the case of such assets as plant and machinery, this decreasing charge for depreciation is justified, as the cost of repairs will be increasing each year as the plant grows older, but, in the author's opinion the question of repairs should be dealt with quite apart from depreciation, and fluctuations may be provided for by the creation of maintenance reserves This method of writing off depreciation is the one most commonly used in this country in connexion with plant and machinery, as it is simple, and separate calculations do not have to be made in the case of additions, as such additions increase the balance upon the Plant Account, and the percentage is calculated upon this increased figure

The great weakness of this system is that it takes a very long time to write an asset down to approximately

nil, unless a very high rate is used, in which latter case the burden upon the opening years is excessive For example, if an asset costing £1000 is depreciated at 10 per cent under this system, at the end of forty years there will still be a balance of £14 upon the asset account, and to write £1000 off over a period of ten years, ignoring the residual value, the rate will have to exceed slightly 25 per cent, but taking 25 per cent the charge for depreciation at the end of the first year will be £250, for the fourth year it will be £105, for the sixth year, £60, and the ninth year £25 —so that it will be seen what an enormous charge is placed upon the first year or two, and how rapidly the charge in succeeding years reduces These facts are seldom appreciated when this system is adopted in practice, and the rate fixed is generally quite inadequate to write the asset down in a reasonable period In the author's opinion this system is a thoroughly bad one and has resulted, in numerous cases, in totally inadequate provisions for depreciation When this system is adopted, an auditor should see that the rate per cent is sufficient to write the asset down during the period of its estimated working life

The foregoing views are endorsed in an article in *The Accountant* (Vol XCVIII, page 652), which stated—

> In this country the prevalent reducing balance method may have served very well in the days when long-dated assets were the rule, but the current progressive change towards a shorter life of industrial plant has, in our opinion, revealed the grave weakness of the plan adopted by the Inland Revenue for wear and tear allowances and copied, largely by force of example, by the great majority of British undertakings We think that accountants in this country can render no better service than to point out, whenever opportunity arises, the great advantages of abandoning the reducing balance plan in favour of its more scientific competitor

The scientific competitor referred to above is, of course, the straight line system

DEPRECIATION FUND SYSTEM Under this system, during the period of the estimated life of the asset an equal amount is written off each year for depreciation, Profit and Loss Account being debited, and a Depreciation Fund Account being credited, at the same time a similar amount of cash is withdrawn from the business, and should be invested in "gilt-edged" securities, cash being credited and an Investment Account debited The income yielded

by the investments as received is debited to cash and credited to the Depreciation Fund Account, at the same time this income should be re-invested, cash being credited, and the Investment Account debited After all income received has been re-invested, the credit balance upon the Depreciation Fund Account will equal exactly the debit balance upon the Investment Account Under this system it will be seen that the amounts retained for depreciation are withdrawn from the business, and thus at the end of the life of the asset the investments can be realized, and will produce a sum of cash immediately available towards the replacement of the expired asset The debit balance upon the old asset account will be written off against the credit balance upon the Depreciation Fund Account This method is a sound one to adopt where it is desired to make certain that the cash necessary for the purpose of replacement will be available In practice it is not uncommon to find that the funds representing depreciation provisions have become locked up in the general assets of the business, and, therefore, are not immediately available for the replacement of the asset at the end of its life For this reason, upon the grounds of financial policy, this system has much to recommend it

INSURANCE POLICY SYSTEM Under the Depreciation Fund system there is always a risk that the investments may not realize cost price, and that thus the exact sum required may not be obtained, therefore, to obviate this, a policy is taken out with an insurance company under which the required sum to replace the asset is payable at the end of the period of the asset's estimated life In this case, an amount equal to the amount of the annual premium is debited to Profit and Loss Account each year and credited to a Depreciation Fund Account, and the premium, when paid, is credited to cash and debited to a Policy Account At the end of the term, the amount received under the policy is credited to the Policy Account, which account will show a credit balance which represents the interest allowed by the insurance company This credit balance is transferred to the credit of the Depreciation Fund Account, making the credit balance upon this account

exactly equal to the amount received under the policy If the old asset is now of no value, the debit balance upon the old asset account will be written off against the credit balance upon the Depreciation Fund Account, and the proceeds of the policy are available for the replacement of the asset In the case of miscellaneous equipment, this system would not be suitable owing to the constant replacements that have to be provided for This system can be utilized only in the case of assets with a known period of life such as a lease

ANNUITY SYSTEM This system is sometimes adopted in cases where the amounts charged for depreciation are to be retained in the business, and it is wished to take into account interest upon the capital invested in the asset From tables a fixed amount to be written off for depreciation each year is ascertained, which sum, after taking credit for interest at an agreed rate upon the reducing balance of the asset, will write the asset down to nil at the end of the period of its estimated life The annual charge for depreciation will be credited to the asset account and debited to Depreciation Account, whilst the interest, calculated upon the reducing balance, will be debited to the asset account and credited to the Depreciation Account The amount written off for depreciation is the same each year, but the interest taken credit for becomes less each year, and therefore, the annual net charge (that is, depreciation, less interest) grows heavier each year The orthodox argument for this is that the amounts set aside each year for depreciation are adding to the available working capital of the business, and as the business will be using these sums and presumably be earning income therewith, the question of interest should be taken into account For example, in the case of a lease for a period of twenty years and costing (say) £10,000, in the first year, capital to the amount of £10,000 is locked up in this lease, but as the depreciation is provided each year, this capital is recouped, and, for instance, during the last year nearly £10,000 has been provided out of revenue—this amount forming additional working capital, of which the business has the use in the meantime Therefore, the increasing charges for depreciation, caused by the diminishing interest taken into account

are compensated for by the earnings of the accumulations of depreciation which are increasing the working capital This system is seldom used in practice, and the only items to which it is sometimes applied are leases, in which case the period of life is known exactly, and there is no question of additions Many authorities, however, contend that interest should not be taken into account in calculating depreciation, and with this view the author is in agreement

BASIS OF USE One of the main factors causing depreciation of equipment is use For example, in the case of motor vehicles it is the mileage run that is the principal factor and not time Under this method of calculation the life of the motor vehicles would be estimated at so many thousand miles, and this figure divided into the net cost would give the amount of the depreciation per mile Each year depreciation would be written off, calculated at this rate on the number of miles run during the year In the case of other plant, the life can be estimated in production hours and depreciation calculated in the same way, based upon the productive hours worked during the year or period Many modern accountants strongly favour this method in the case of certain assets This system involves the keeping of detail records of the use of each item of plant and, for this reason, is impracticable in many cases

RE-VALUATION Under this system the assets are revalued each year, and this is the most satisfactory method to adopt with such assets as loose tools, harness, live stock, patents, copyrights, and other assets of this nature, because it is almost impossible to fix rates of depreciation that will work out accurately, since these assets are constantly changing, and their period of life is most uncertain Such valuations should be upon the "going concern" basis

The Treatment of Depreciation in Accounts

In this country the most common practice in the case of industrial plant and equipment is to provide for depreciation by means of the reducing instalment system, although there is a growing swing over in favour of the straight

line method The annual amounts written off are generally credited to the asset account and debited to Profit and Loss Account Under this method the asset appears each year in the Balance Sheet at the written down balance

In America and on the Continent the common practice is each year to credit the annual provisions for depreciation to a Depreciation Reserve Account During the lifetime of the asset, therefore, the annual provisions are accumulated in the Depreciation Reserve Account, and this account, therefore, at any time shows the total depreciation written off to date

Under this method the assets appear in the Balance Sheet at the original cost and the balance on the Depreciation Reserve Account is either shown on the left-hand side of the Balance Sheet as a separate item or shown in total as a deduction from the appropriate asset The writer prefers the latter method of presentation

In the writer's opinion this method results in a much clearer and more informative picture being presented than does the orthodox British method, as it shows the total depreciation provided up to the date of the Balance Sheet, and thus it can be seen at a glance what proportion of the original cost of the fixed assets has been provided for by means of depreciation

Under this system when an item of plant is discarded the original cost less the proceeds of sale (if any) will be credited to the asset account and debited to the Depreciation Reserve Account, provided that the depreciation accumulated in respect of the particular unit covers this amount, if it does not the difference should be written off to Profit and Loss Account as the loss on the discarded asset and represents the insufficient depreciation provided for during the lifetime of the asset

Are the Orthodox Methods Satisfactory?

In this chapter the writer has attempted to describe the orthodox methods adopted in this country for writing off depreciation, but he is extremely doubtful whether it is satisfactory that there should be so many alternative methods of calculation all of which give widely different results The writer's views upon this point are recorded in

the Proceedings of the International Congress of Accounting held in 1933, and may be summarized as follows

In his opinion, it is most desirable that there should be uniformity of method, as costs are directly affected It is not uncommon to find that depreciation represents 100 per cent on direct labour This being so it will be realized how considerably individual costs may be affected by the method adopted for calculating depreciation If the various manufacturers in an industry all calculate their costs in different ways, giving widely varying results, the consequences may be and in many cases undoubtedly are most detrimental to the industry as a whole

The common contention of the profession is that the selection of method depends upon circumstances, but the writer's opinion is that this is merely an excuse for shirking the responsibility of making up our minds American accountants have made up their minds in favour of the straight line method, which is more or less universally adopted in that country It would seem to be most desirable that we in this country should make up our minds also The writer would unhesitatingly recommend that we should follow the American lead in this matter and adopt the straight line method

The foregoing are personal opinions and, therefore, for examination purposes students will be wise to make themselves familiar with the orthodox views upon this matter The writer's opinions, which are shared by many accountants in this country, are explained in the hope that they will stimulate thought upon a subject that is of great importance to industry

The Auditor's Duties as Regards Depreciation

As has already been pointed out, it is impossible for an auditor to estimate the working lives of the assets of a business, consequently, he cannot estimate the amounts that are necessary to provide for depreciation, but he should see that this subject has been properly considered, and that correct principles have been applied He should ascertain upon whose advice the amounts written off for depreciation have been fixed, that the working lives have been honestly estimated, and that the rates written off

are sufficient to reduce the particular assets to nil by the end of such periods If he finds that this question has been properly and thoroughly considered, he has no further concern, even though he may think it would be wise to write off larger amounts, for an auditor must appreciate that he has no expert or technical knowledge of such assets as plant and machinery, and that, therefore, he should accept the opinions and conclusions of those who have such knowledge But, on the other hand, should it be palpable that sufficient depreciation is not being provided for, or if he finds that this question has not been adequately and honestly considered, the rates and amounts having been fixed, either in a haphazard manner, or with a view to inflating the profits, then he should state definitely in his audit report that he is not satisfied that the provisions are sufficient However, before taking this course, he should discuss the whole question fully with the management, hearing their views, and laying his before them, if, thereafter, he is still not satisfied, and the directors or partners refuse to alter the accounts, he should then report as stated above

General Considerations of Reserves

The word "reserve" has been used very loosely in connexion with accounting, with the result that misconceptions have arisen with regard thereto in the mind of the general public Even in the accountancy profession, there is some difference of opinion in connexion with this subject The reason for this is that the term "reserve" has been used in widely different senses, and to describe very diverse states of affairs, e g the term "reserve" is used in connexion with (*a*) provisions for outstanding liabilities and contingencies, (*b*) reductions in the valuation of assets such as book debts, inventories, etc , and (*c*) appropriations of available profits In the writer's opinion it would be extremely helpful if the profession could establish an agreed terminology

Reserves may be subdivided under the following headings—

Specific Reserves	Reserve Funds
General Reserves	Capital Reserves
Sinking Funds	Secret Reserves

and it is proposed to consider briefly each of these subdivisions

Specific Reserves

A specific reserve represents a sum *charged* against profits to provide for a known contingency, the exact amount of which, however, cannot be ascertained, and has, therefore, to be estimated, such as reserves for bad debts, discounts, depreciation, future repairs and renewals, disputed claims, etc For example, in the case of reserves for bad debts and depreciation, it is known that the assets are subject to loss in value under these heads, but the exact amount of such loss has to be estimated and provided for by means of specific reserves In these cases, the reserve should be charged to Profit and Loss Account, and deducted from the corresponding asset in the Balance Sheet In the case of specific reserves for accruing repairs and renewals, and for disputed claims, it is known that a liability will arise, but the exact amount thereof cannot be ascertained, and again, therefore, the amount has to be estimated and debited to Profit and Loss Account In this latter case the amount provided will appear upon the left-hand side of the Balance Sheet, and is in effect merely a provision for a liability that has had to be estimated

Specific reserves are a charge against revenue, and must be provided for whether the Profit and Loss Account shows a profit or a loss In fact, if a loss, it is most important that ample provision should be made under these heads, in order that it may be seen exactly to what extent the capital of the concern has been depleted

In the above circumstances, it is thought that the term "reserve" has been badly used, and it would be better to use some other term, such as "provision", but if the word "reserve" is used, it should always be followed with explanatory words, such as "for bad debts," "in respect of disputed claims," so that the exact circumstances may be clearly appreciated

General Reserves

A general reserve represents sums set aside *out of profits*, to provide against unknown future contingencies, to

increase the working capital, to equalize dividends, or merely to strengthen the financial position of the concern A general reserve pre-supposes a profit and is *an appropriation of profits* In other words, a general reserve represents profits retained in the business, which are ear-marked for any of the above purposes, and, in fact, these reserves might well be described in the Balance Sheet as "undivided profits" A true profit must be represented by a corresponding surplus of assets over capital and liabilities, and, therefore, as a general reserve is created by retaining part of such profits, it must, in its turn, be represented by a corresponding surplus of assets In fact, it is of the essence of a general reserve that it should consist of such a surplus of assets The credit balance upon the General Reserve Account, which appears upon the left-hand side of the Balance Sheet, represents merely the gauge which measures the amount of the surplus of assets that are withheld from distribution to the proprietors of the business The continued existence of the reserve is absolutely dependent upon the continued existence of the corresponding surplus of assets, so that if, for example, in the succeeding year the business makes a loss in trading, equal to or exceeding the amount of the general reserve set aside out of the previous year's profits, then such reserve has automatically disappeared, as the surplus of assets has disappeared by reason of the subsequent loss In these circumstances, therefore, the credit balance upon the General Reserve Account should be written off against the debit balance upon the Profit and Loss Account

As a general reserve represents a surplus of assets over capital and liabilities, it will be appreciated that its existence depends upon the valuation of the assets, for if the assets have been over-valued, as for example by insufficient provisions for bad debts and depreciation, then to the extent of such over-valuation of assets the surplus is non-existent In the same way, the over-valuation of other assets has the effect of inflating the general reserves, and, to the extent of the excess, the reserve shown upon the Balance Sheet will be absolutely fictitious, and non-existent

Reserve Funds

A reserve fund is the same as a general reserve, except that the surplus of assets representing the reserve is invested outside the business These investments should be "gilt-edged" securities This definition is not accepted by all the authorities, but it is suggested that the use of the word "fund" conveys to the general public that there is a distinct fund representing the reserve, that can be converted into cash whenever required

A reserve fund is created by debiting Profit and Loss Account, and crediting a Reserve Fund Account, and at the same time an equal amount of cash is withdrawn and invested These investments should be separately stated in the Balance Sheet, and should be described as being held on account of the reserve fund

Capital Reserves

These represent reserves created out of surpluses of a capital nature, such as a surplus upon a revaluation of fixed assets, a premium on an issue of share capital, realized capital profits, etc

In the case of a surplus upon a revaluation of fixed assets, the auditor should see that this is supported by a *bona fide* valuation by an outside valuer Such a Capital Reserve could be used only for capital purposes and in no case to absorb revenue losses or charges

Such a reserve should be shown separately in the Balance Sheet and be described as a "Capital Reserve"

Investment of Surplus of Assets Representing General Reserve

Discussion has taken place from time to time as to whether the surplus of assets representing a general reserve should be invariably invested outside the business, but this is a matter of financial policy which is entirely in the hands of the proprietors of the concern If the object with which the reserve has been created is to provide additional working capital, for which very good use can be found in the business, then obviously the surplus of assets must be left in the business In many cases this is a very wise course to adopt, as additional capital becomes available with

which to extend the business, and upon which no interest is payable. In fact, most large and successful concerns have been built up from small beginnings by withholding profits, and thus providing the additional capital which, of necessity, is required by an increasing and expanding business. Therefore, it will be seen that this is a question with which an auditor has no concern, and that accountants cannot dictate the use that the proprietors of a business shall make of the funds of their business.

On the other hand, if a reserve is created with a view to providing the funds with which to meet unknown contingencies and liabilities that may suddenly arise in the future, then it is wise to invest the surplus outside the business, so that it may be in a form that is readily realizable into cash. Otherwise, the surplus assets will be used as additional working capital, and when the emergency arises, it may be found that these funds are locked up in such assets as stock, book debts, or plant and machinery, which cannot be immediately converted into cash without seriously disturbing the operations of the business.

In order to draw a distinction between these two positions which theoretically are the same, but which from a practical point of view are different, it is suggested that where the surplus assets representing a reserve are left in the business, the term "general reserve" should be used, but where the surplus is invested outside the business, the term "reserve fund" should be adopted.

The investment of a surplus representing a reserve outside the business does not and cannot fix the existence of such reserve, which is absolutely dependent upon the continued existence of a surplus of the whole of the assets (including the ear-marked investments) over the capital and liabilities; if, subsequently, losses are incurred, the surplus is thereby automatically reduced, and, therefore, the reserve to this extent is also reduced, even though the investments may be still in existence. If a loss equal to the amount of the reserve fund is incurred, the reserve disappears entirely, and the credit balance thereon should be written off against the loss; the investments are then part of the general assets of the concern, and are required to provide for the liabilities and capital. It is absolutely

impossible permanently to fix the amount of a surplus, which must of necessity increase or decrease from time to time, according to the fortunes of the concern

Sinking Funds

A sinking fund is very similar to a reserve fund, except that it is created for the definite purpose of redeeming a liability Profits are appropriated and credited to a Sinking Fund Account, and at the same time corresponding amounts are invested outside the business The income earned by the investments should be credited to the Sinking Fund Account and re-invested The term "sinking fund" is also sometimes used where provision is made for the replacement of a wasting asset, but, in these circumstances, "depreciation fund" is a better term A depreciation fund, as has already been described in the earlier part of this chapter, is created in an exactly similar manner

In the case of a sinking fund created to redeem a liability, the periodical debits to Profit and Loss Account represent appropriations of profits, and, after the liability has been paid off, a credit balance is left upon the Sinking Fund Account, which then represents a general reserve accumulated out of divisible profits For example, suppose the case of a company having a debenture debt of £10,000, repayable at the end of ten years, and it is decided to provide for the repayment of the debt by means of a sinking fund At the commencement of the period the Balance Sheet would be as follows—

(1) BALANCE SHEET

	£		£
Capital	15 000	Assets	25,000
Debentures	10 000		
	£25 000		£25 000

At the end of the period, and before the repayment of the debentures, the Balance Sheet will be as follows—

(2) BALANCE SHEET

	£		£
Capital	15,000	Assets	25 000
Debentures	10,000	Sinking Fund Investments	10 000
Sinking Fund	10,000		
	£35 000		£35,000

If now the sinking fund investments realize their cost exactly, the £10,000 produced will be used to pay off the debentures, and the Balance Sheet will be as follows—

(3) BALANCE SHEET

	£		£
Capital	15 000	Assets	25 000
General Reserve	10,000		
	£25 000		£25 000

The above should be compared with Balance Sheet No 1, when it will be seen that the positions are identical, except that the liability to outside debenture holders has been replaced by the general reserve, which represents undrawn profits If no sinking fund had been created, when the debentures became due, the company would have had to re-borrow money or sell part of its general assets, instead of which it has voluntarily held back profits, and in this way has accumulated the necessary funds with which to pay off the liability Originally, the shareholders had £15,000 only invested in the business, but now they have £25,000 invested, the further £10,000 representing divisible profits that have been left in the business, and which have been used to pay off a capital liability

A depreciation fund created to replace a wasting asset is built up in the same way, but, upon completion, the debit balance upon the account of the old and now expired asset is written off against the credit balance upon the Depreciation Fund Account, which latter account thus disappears, and the investments provide the cash with which to purchase the new asset In this case, the annual debits to Profit and Loss Account are a *charge* against profits, as they represent the provision for the depreciation of the wasting asset

Capitalization of General Reserves

In the case of companies, if substantial general reserves have been accumulated, it is common for such reserves to be capitalized by the issue to the shareholders of bonus shares fully paid up

The accumulation of a general reserve has increased the working capital of the company and, therefore, its

earning capacity If in this way profits are substantially increased the dividends declared may be at a high rate per cent The high rate of the dividends may result in dissatisfaction of customers, employees, suppliers, etc For example, the original share capital of a company might be £50,000 and it might have accumulated £30,000 on General Reserve Account In that case the true capital employed is £80,000, and not £50,000, upon which the rate of the dividend is calculated If, therefore, the £30,000 were capitalized by the issue of bonus shares the share capital would be £80,000, which would be in line with the true capital employed, and the rate per cent of the dividend would be substantially reduced, although the total distribution to the shareholders would be the same

There must be power in the Articles of Association to issue bonus shares, if not the Articles will require to be altered by special resolution

The auditor will require to see that all of the legal requirements have been complied with and he must inspect the minutes recording the necessary resolutions of the directors and shareholders

Secret Reserves

A secret reserve is a reserve that is not disclosed in the Balance Sheet, so that the financial position is, in fact, better than appears from the Balance Sheet Secret reserves are created for the purpose of equalizing dividends, or to provide a fund out of which heavy losses can be met, without disclosing the fact to the shareholders and general public, also, in some cases, to avoid disclosing information to trade rivals

Secret reserves are created by writing down assets, such as stock, book debts, plant and machinery, and premises, below their true value, by making excessive provisions for outstanding liabilities, and by charging capital items, such as additions to plant and machinery, to Profit and Loss Account

The Auditor's Position as Regards Reserves

In the case of specific reserves, the auditor must inquire into these most carefully, with a view to satisfying himself

that the provisions made are sufficient His duties as regards these reserves, such as bad debts, depreciation, and outstanding claims, have been discussed already

The auditor is not concerned with the creation of general reserves, except that he must see that the accounts have been properly taken, and do show a bona fide surplus, and that the reserves are clearly and properly stated in the Balance Sheet If the reserves are fictitious, owing, for example, to the over-valuation of stock, or the insufficient provision for depreciation and bad debts, then the auditor must deal with the whole question in his audit report If the accounts are in order and disclose profits, an auditor cannot insist upon the creation of general reserves, as that is a matter entirely outside his province, except in the case of a company when the Articles of Association specially provide for the creation of such reserves, however, in practice, auditors are often asked to advise as regards these matters Again, an auditor cannot insist upon the surplus assets representing a general reserve being invested outside the business, his duty being confined to seeing that the true position of affairs is disclosed in the accounts In the same way, he cannot demand that a sinking fund be created to redeem a liability, such as debentures, except in the case of a company, when it is so provided in the Articles of Association, or the terms of issue

The auditor's position with reference to secret reserves is one of considerable difficulty The most recent case dealing with this matter is the *Royal Mail Steam Packet* case, which is dealt with fully in Chapter XII, and every accountant and student is recommended to study the whole of this case closely, as the questions involved are of the utmost importance to the profession As a whole, the profession has not made up its mind upon this subject, but it is of vital importance that it should do so, and in practice accountants should not act upon the technical rules, but upon the spirit As to this there is no question but that in recent years practices which have been accepted in the past are being challenged, and public opinion is definitely demanding more informative accounts Theoretically, there can be no question that secret reserves cannot be justified, and it may be said that in such circumstances the auditor

cannot report that the Balance Sheet shows a true and correct view of the state of affairs of the concern But in the case of large public companies, especially in the case of banks, these reserves are common and in practice auditors commonly do not refer to such secret reserves in their audit reports

In the case of partnerships, secret reserves are not common, and, if in existence, all the partners should be made aware of the fact In the case of private companies, where the number of shareholders is small, and the accounts are not in the hands of the public, it is difficult to justify the existence of secret reserves In such circumstances, all the shareholders are entitled to see the full position of affairs, and, therefore, if secret reserves, to any material extent, have been created by the directors, it is advisable that the auditor should make this fact clear in his audit report But it is commonly contended that the circumstances with large public companies are entirely different, for the accounts are published and are thus available for the general public, the customers, creditors, and competitors of the company, as well as the shareholders, and, therefore, it is a matter of very great importance to consider the effect that information disclosed in the accounts may have upon the concern Such companies, therefore, often create these secret reserves so that they may be able to meet emergencies and heavy losses without disclosing to the whole world that they have met with such reverses This, it is argued, is in the interests of the shareholders as a body, as in this way the public credit of the concern is maintained Many are of opinion that this need for secrecy is greatly exaggerated, and that in view of the growing public demand for informative accounts, in the great majority of cases, the wise course would be to disclose all such reserves in the Balance Sheet

Secret reserves can be used by unscrupulous directors for most improper purposes, for example to cover up losses upon *ultra vires* transactions, for the purpose of private speculation in the shares of the company, for the market value of its shares may be influenced by making the results shown by the accounts fluctuate improperly by the manipulation of secret reserves created in the past or to conceal

from the shareholders the fact that profits are fluctuating greatly or declining. In all cases where secret reserves exist it is of the utmost importance that the auditor should inquire into the whole of the circumstances with a view to ascertaining exactly what reserves have been, and the purpose for which they have been, created, and he must carefully review the whole of the circumstances of the case. If he is satisfied that such reserves are necessary in the interests of the company he may decide to pass the matter without reference in his report, but he must appreciate the responsibilities of this decision.

In such circumstances some auditors make a general statement in their report, for example, that the value of certain assets is understated, thereby disclosing the fact that there is a secret reserve, the amount of which is not shown. Such a statement in the auditors' report is not very helpful to the shareholders except to the extent that it enables them to press for information, if they so desire. If, however, the auditor is not absolutely satisfied as to the bona fides of these transactions, he should, without fail, deal with the matter fully in his report to the shareholders and even though he is satisfied as to the bona fides of these transactions, if he does not approve of the creation of such reserves, he is fully empowered and entitled to deal with the matter in his report, should the directors refuse to alter the accounts.

If secret reserves, created in past years, are drawn upon to bolster up the current year's earnings, then, if the amount is substantial, the writer is firmly of opinion that the auditor should insist upon this fact being disclosed to the shareholders. Otherwise the shareholders would be presented with a misleading view of the normal earnings of the particular year. For the same reasons the writer's view is that all amounts drawn from past reserves, windfalls and non-recurring items, if credited to Profit and Loss Account, should be shown under a separate heading, so that the proprietors of the business may obtain a clear view of the normal earnings for the period.

Upon exactly the same reasoning, if abnormal and non-recurring losses or charges have been incurred during the

year, any such items should, in the writer's opinion, be separately stated in the Profit and Loss Account in order that a clear view may be obtained of the normal earnings for the period

The policy of creating secret reserves is a very debatable one In the past, management in this country was greatly in favour of the creation of such reserves, and there is no doubt that this secrecy complex still exists It is very questionable whether this policy is a wise one, and it is difficult to understand what real damage a company could suffer by disclosing increased financial strength A considerable movement has developed in recent years demanding fuller information as to commercial and industrial finances, the interested parties being the shareholders, labour, the consumer and the State, and, in the opinion of many, the wise policy for the future would be to discard secrecy and adopt the principle of full and open accounting The attitude of auditors as regards secret reserves has been challenged, the whole subject, therefore, is one which merits serious consideration, and it would seem wise that the profession should strive towards greater uniformity of practice than exists at the present time

The most helpful contribution to the discussion of this most important problem is contained in a paper entitled "Some Observations on Company Balance Sheets," by Lord Plender (*The Accountant*, Vol LXXXVI, page 212), and in which Lord Plender stated—

> Inner or secret reserves and their propriety—if not legality—have recently been the subject of judicial comment Such reserves may exist, for example, in the excessive writing down of the book values of assets, of under-valuation of investments, or in provisions for contingencies the amount of which is not specifically set out on the Balance Sheet In my opinion directors should be entitled, in the interests of a company and its shareholders, to make reasonable provisions for contingencies and should be allowed discretion in so doing without necessarily being required to disclose the amount of the provisions in the Balance Sheet Many shareholders have good reason at the present time to appreciate the wisdom of such a policy where it has been adopted, and others to regret the absence of inner reserves The reserve for contingencies is generally included in an omnibus item on the liabilities' side of the Balance Sheet (such as "Creditors including provision for contingencies"), and in my view it is necessary that its existence should be indicated by suitable wording The use of such reserves in relief of losses or by way of supplement to profits should, I think, be indicated to the shareholders, and except in comparatively rare cases the amount so used should be stated The origin

and utilization of undisclosed reserves covers such a wide field of circumstances that it is not possible to dogmatize on the question, and a decision as to the right course to pursue can only be arrived at after a full consideration of the facts in each individual case

In the case of banks, the fact that they have substantial secret reserves is well known A bank is in a special situation, as the maintenance of its credit is vital to the existence of the bank The justification of secret reserves in their case is much stronger than in the case of the ordinary commercial company

CHAPTER VIII

SECTIONS OF THE COMPANIES ACT, 1929, PARTICULARLY AFFECTING AUDITORS

It is necessary that an auditor should be familiar with the greater part of the provisions of the Companies Act, 1929, but in the space available it is only possible to deal briefly with those sections of the Act that are of particular importance from an auditor's point of view

Several important changes in the law were introduced by the Companies Act, 1928, particularly as regards the accounts of companies The Companies Act, 1929, consolidates all previous Acts and, therefore, incorporates the Act of 1928

Keeping of Books of Account

Section 122 provides that every company shall keep proper books of account, in which shall be recorded particulars of all sums of money received and expended by the company, all sales and purchases of goods, and particulars of the assets and liabilities The books of account must be kept at the registered office of the company or at such other place as the directors think fit, and shall at all times be open to inspection by the directors Failure by the directors to comply with the provisions of this section may be punishable by imprisonment for a term not exceeding six months or to a fine not exceeding £200

Profit and Loss Account

Section 123 provides that the directors of every company must lay before the company in general meeting once in every calendar year a Profit and Loss Account, or, in the case of non-trading companies, an Income and Expenditure Account, and this account is to be made up to a date not more than nine months, or, in the case of a company carrying on business or having interests abroad, not more than twelve months before the date of the meeting In the case of a new company, the Profit and Loss Account must be made up to a date not later than eighteen months

after the incorporation of the company Although the section provides that the Profit and Loss Account shall be submitted, no particulars are given as to the form of the account The object of the section undoubtedly is that the shareholders shall be given particulars as to the trading transactions for the period under review Owing, however, to the terms of the section, it is possible, and not uncommon, for companies to prepare the published Profit and Loss Account in a very condensed form, which affords very little information

The *Royal Mail Steam Packet Co* case was the first one to raise the important question of the auditor's responsibilities as regards the Profit and Loss Account In consequence of this case also considerable attention has been directed towards consideration of the form of presentation of the published Profit and Loss Accounts of companies In order that shareholders may be enabled to obtain a fair view of the financial condition of the company in which they are interested, the Profit and Loss Account is all important, as it is only by this means that the earning capacity of their investment can be gauged The true value of the assets of a business—with certain exceptions—is dependent upon their capacity to earn profits

In a lecture (*The Accountant*, 13th February, 1932, Vol LXXXVI, page 205), which every accountant should study, Lord Plender stated—

> As regards the Profit and Loss Account, it may be found that in a number of instances the information given in this account, however
>
> [illegible]
>
> the form in which the Profit and Loss Account shall be submitted to shareholders, or the amount of detailed information which it should contain This absence of definition is not to be condemned as it would be difficult, if not impossible, to legislate in a manner which covered fairly and adequately the majority of the cases—widely differing from each other —which are encountered in practice There can be no exception to general

legislative requirements unless provided for specifically, and therein lie very considerable difficulties The general practice among public companies—and I am thinking in particular of those owning industrial undertakings—is to submit the Profit and Loss Account in an abbreviated form Most frequently reasons of policy in the best interests of the shareholders themselves dictate this procedure But I am bound to observe that one does, in practice, meet with cases where prima facie, considerably more information could quite well be afforded without the company's interests suffering in any way These cases are few in proportion to the whole but they are not so few as to be negligible

A recent case in the Courts connected with the Royal Mail Steam Packet Co has given rise to the question of the form generally of Profit and Loss Accounts The facts, as disclosed, were exceptional, particularly in regard to the degree and extent of items included in the Profit and Loss Account of a particular year which were not connected with the year's normal operating results The shareholders could not see from the accounts what were the true working results each year of the business which the company was formed to carry on Extraneous and special credits were brought in of large amount which gave an appearance of considerable profits being earned which might be regarded as normal The facts brought out dispelled this conclusion I am not referring to the legal aspect of the case, but to the impression conveyed to the ordinary mind

That case centred around a question of principle, i e whether the annual Profit and Loss Account was misleading by including as part of the year's results, without sufficient or clear indication, abnormal credits not relating to the year in question Apart from this particular matter, the question of the form of the Profit and Loss Account was not in issue

I have read suggestions as to a "lead" being given for the improvement of the Profit and Loss Account, by that is meant, I suppose, more information in cases where there is a paucity of information I am entirely in favour of Profit and Loss Accounts being more informative in many instances, and suggestions are often made by auditors to directors to be more communicative But as the accounts are the accounts of the directors, an auditor cannot go beyond suggestions, if he is satisfied that the accounts submitted to the shareholders—that is the Balance Sheet and the Profit and Loss Account—are not misleading, but in fact give a fair picture of the position, based, of course, on sound accounting principles If certain shareholders desire to have more informative accounts they should represent their views to the directors, and the chairman at the annual general meeting will deal with the question, and if he is supported by the majority of shareholders present in withholding information which he thinks it is not in the company's best interests to disclose, matters must remain as they are

Lord Plender concluded by saying—

Whilst I feel, for the reasons given, that a stereotyped form of Profit and Loss Account is not practicable, I think that in the preparation of all Profit and Loss Accounts certain general principles should be followed in order to ensure as far as possible that the net results fairly attributable to the year's operations upon a basis comparable year by year should be shown, and that extraneous and abnormal items should be stated separately

Mr H Morgan, formerly President of the Society of Incorporated Accountants and Auditors, also dealing with this subject in a speech (*The Accountant*, 5th March, 1932, Vol LXXXVI, page 303), stated—

In so far as our own profession is concerned, there seems to be a considerable diversity of opinion as to the amount of information which should be disclosed in the published accounts and the principles that should be observed in their preparation

In the author's opinion, it is desirable that the profession should make up its mind upon these points Mr Morgan expressed the view that the form in which the Profit and Loss Accounts of many companies are presented is open to severe criticism, and he stated that in his opinion amending legislation was urgently necessary

In order to obtain a clear view as to the affairs of any concern it is necessary to study both its Balance Sheet and Profit and Loss Account It was no doubt for this reason that the Companies Act, 1929, provided for the publication of the Profit and Loss Accounts, but owing to the fact that the section did not define what information should be disclosed, in many cases the information given is practically only that which would be disclosed in an Appropriation Account In these cases, undoubtedly, the spirit of the section is not being carried out

In the writer's opinion, the Act should be amended with a view, if possible, to laying down the principles upon which the Profit and Loss Account as submitted to the shareholders should be prepared In the meantime the influence of accountants should be directed towards the disclosure of a reasonable amount of information in this account

Remuneration of Directors

Section 128 (1) provides that the total of the amounts paid to the directors as remuneration for their services, inclusive of all fees, percentages, or other emoluments paid to or receivable by them from the company, or from any subsidiary company, shall be shown separately in the accounts The provisions of this section, however, do not apply to a managing director of a company—see Section 128 (3) In the case of other directors who hold any salaried employment or office in the company, all that it is necessary

to disclose is the amount paid to them by way of directors' fees If these particulars are not disclosed, then it will be the duty of the auditors of the company to include this information in their report on the Balance Sheet

It will be observed from the foregoing that the amount to be disclosed covers directors' fees only, and not salaries or emoluments paid to directors who hold salaried offices in the company

In this connexion, Section 148 provides that on receipt of a demand in writing by members of the company holding not less than one quarter of the aggregate number of votes, the directors must furnish to all members of the company a statement, certified by the auditors of the company, showing for the last three years the aggregate amount received in each year by way of remuneration or other emoluments by persons being directors of the company This statement must include emoluments received by directors holding salaried offices The aggregate amount only need be stated, and not the amount received by individual directors The total must also include the fees and emoluments received by directors from subsidiary companies, and from other companies on the boards of which they have been nominated There shall be included in the aggregate any sums paid by way of income tax or sur-tax on behalf of directors in respect of their remuneration or emoluments

Balance Sheet

Section 123 requires that the directors shall lay before the company in general meeting a Balance Sheet once in every calendar year, made up to the date to which the Profit and Loss Account, or Income and Expenditure Account, is made up, and there shall be attached to every such Balance Sheet a report by the directors in respect of the state of the company's affairs, and their recommendations as regards dividend and transfers to reserve accounts Failure by a director to comply with the provision of this section involves a liability to imprisonment for a term not exceeding six months, or to a fine not exceeding £200

Every Balance Sheet of a company shall contain a summary of the authorized share capital and of the issued share capital of the company, its liabilities and its assets, together with such particulars as are necessary

to disclose the general nature of the liabilities and the assets of the company and to distinguish between the amounts respectively of the fixed assets and of the floating assets, and shall state how the values of the fixed assets have been arrived at (Section 124 (1))

The following items must be shown separately in the Balance Sheet so far as they have not been written off—

(*a*) Preliminary expenses

(*b*) Expenses in connexion with an issue of share capital or debentures

(*c*) Goodwill and patents and trade-marks

From the wording of Section 124 (2) (*c*), it is not clear whether goodwill, patents, and trade-marks may form one item in the Balance Sheet or whether (*a*) goodwill and (*b*) patents and trade-marks must be shown as two separate items

If any liability is secured on the assets of the company, then this fact must be stated in the Balance Sheet, although it is not necessary to specify the assets upon which the liability is secured

Loans to directors or officers of a company must be shown separately in the Balance Sheet, not only the amount owing at the date of the Balance Sheet, but the amount that has been advanced and repaid during the period of the account It is not necessary in the Balance Sheet to state the names of the individual directors or officers to whom loans have been made and the individual amounts, but only the total of all such advances These provisions do not apply to a loan made by the company to an employee if the loan does not exceed £2000 and is certified by the directors of the company to have been made in accordance with any practice adopted, or about to be adopted, by the company in respect to loans to employees

If the loans to directors and officers of the company are not disclosed in the Balance Sheet, then it is the duty of the auditors to include this information in their report on the Balance Sheet

In cases where, in accordance with any scheme, a company advances money for the purchase by trustees of fully paid shares in a company, to be held by, or for, the benefit of the employees of the company, including any directors holding salaried employment or office, or the company

makes loans to employees other than directors with a view to enabling such persons to purchase fully paid shares in the company, then the aggregate amount of any such outstanding loans must be shown separately in the Balance Sheet (Section 45 (2))

In the case of holding companies, Section 125 provides that where the assets of the company include shares in or amounts owing by subsidiaries, then the aggregate amount of these assets, distinguishing between shares and amounts owing, shall be shown separately from all other assets The amounts owing by subsidiary companies include loans and current accounts, etc Furthermore, where the holding company is indebted to subsidiary companies, whether on account of loans or otherwise, then the aggregate amount of such indebtedness must be shown in the Balance Sheet separately from all other liabilities

In the case of a holding company, Section 126 provides that there shall be annexed to the Balance Sheet a statement signed by the directors who have signed the Balance Sheet, stating how the aggregate profits and losses of the subsidiary companies have been dealt with in the accounts of the holding company, and how the losses of subsidiary companies have been dealt with, both in the accounts of the subsidiary companies and in the accounts of the holding company. It is not necessary to specify in this statement the actual amount of the profits or losses of any subsidiary company, or to specify the actual amount of the provisions, if any, which have been made in the accounts of the holding company The auditor is in no way responsible for this note, the responsibility for which rests solely upon the directors This note is commonly placed upon the published Profit and Loss Account, which seems to be the more appropriate place for it

The object of these provisions is to make it clear as to whether the holding company's proportion of any losses incurred by subsidiary companies has been provided for in the holding company's accounts, and, on the other hand, in the case of subsidiaries that are making profits, whether the holding company's proportion of the whole of such profits has been taken credit for or only the dividends declared by such subsidiary companies In this latter case

it means that the undistributed profits of subsidiary companies are not taken credit for by the holding company, and from the point of view of the holding company, therefore, such undistributed profits represent, in effect, a secret reserve

A most important point arising in connexion with the audit of the accounts of a holding company is as to whether the auditor should report to the shareholders if, in his opinion, the methods adopted by the holding company, as regards the treatment of the profits and losses of subsidiary companies, are unsound Section 126 merely provides that the methods adopted shall be made clear in the statement annexed to the Balance Sheet, but as this does not disclose the effects of those methods upon the results shown by the holding company's accounts the effect may be to give a misleading view of the position of affairs No settled principles have yet been adopted by the profession, but in the author's opinion the test should be as to whether the result is to give a misleading picture, if so an auditor would be ill-advised not to make the position clear in his report The main factors arising in connexion with this problem are dealt with in Chapters XIII and XIV

If in the case of any subsidiary company the auditor's report on the Balance Sheet of the company is qualified, then in the statement annexed to the holding company's Balance Sheet there shall be included particulars of the qualification in the report of the auditors of the subsidiary company

Section 127 of the Act defines a subsidiary company as one in which the holding company holds "more than 50 per cent of the issued share capital of that other company or more than 50 per cent of the voting power in that other company," or when the holding company has the power "directly or indirectly to appoint the majority of the directors of that other company"

Every Balance Sheet of a company shall be signed on behalf of the board by two of the directors of the company, or, if there is only one director, by that director, and the auditor's report shall be attached to the Balance Sheet, and the report shall be read before the company in general meeting and shall be open to inspection by any member (Section 129 (1))

In the case of all companies, except private companies, a copy of every Balance Sheet, and the auditor's report,

must be sent to all persons entitled to receive notices of general meetings, not less than seven days before the date of the meeting Any member of the company, whether he is, or is not, entitled to have sent to him copies of the company's Balance Sheet, and any debenture holder of the company, is entitled to be furnished on demand, without charge, with a copy of the last Balance Sheet of the company and the auditor's report

In the case of private companies, every member is entitled to be furnished, within seven days, on demand, with a copy of the Balance Sheet and auditor's report, at a charge not exceeding 6d for every hundred words

Appointment and Remuneration of Auditors

The appointment and remuneration of auditors are provided for in Sections 132 and 133 of the Companies Act, 1929, as follows—

> Every company shall at each annual general meeting appoint an auditor or auditors to hold office until the next annual general meeting (Section 132 (1))

It will be observed that the above subsection refers to "every company" registered under the Act, so that private companies are not exempted as is sometimes thought The appointment is made by the shareholders as a body and the auditor is, therefore, acting as their agent to audit the accounts of the directors, who themselves are merely agents of the shareholders, on whose behalf, and for whose benefit, the directors carry on the business. This fact must be thoroughly appreciated and borne in mind by the auditor, for though in the course of his work he is constantly brought into contact with the directors, who conduct the business, yet he is not acting for them at all He is appointed to act as a check upon the directors and to ensure on behalf of the shareholders, who are the proprietors of the business, that the directors carry on the undertaking honestly for the benefit of the shareholders and render to them true and correct accounts

If an appointment of auditors is not made at the annual general meeting, the Board of Trade may, on the application of any member of the company, appoint an auditor for the current year In this case, although the Board of

Trade makes the appointment, the auditor acts as the agent of the shareholders in exactly the same way as if he had been appointed at the annual general meeting, and he does not specifically act on behalf of the member who applies to the Board of Trade, but on behalf of the whole body of shareholders

Section 132 (3) provides that no person other than the retiring auditor shall be capable of being appointed auditor at an annual general meeting unless due notice of the intention to nominate that person has been given by a member of the company not less than fourteen days before the annual general meeting, and the company must send a copy of any such notice to the retiring auditor, and to the members, not less than seven days before the annual general meeting If, after such notice has been given, an annual general meeting is called for a date fourteen days or less after the notice, such notice shall be deemed to comply with the subsection

In the past cases arose in which conscientious auditors who carried out their duties properly, and in consequence came into conflict with the directors, were not re-elected at the annual general meeting, the directors nominating someone else for the appointment without giving any notice beforehand to anyone Therefore, these provisions were first introduced by the Act of 1907 so that no person, other than the retiring auditor, can be appointed unless due notice has been given both to the shareholders and to the retiring auditor, who thus has an opportunity of laying his case before the shareholders The second part of the subsection provides that the notice of intention to nominate an auditor cannot be frustrated by the simple expedient of immediately summoning the annual general meeting, and fixing the date less than fourteen days from the receipt of the notice

Subject as hereinafter provided, the first auditors of the company may be appointed by the directors at any time before the first annual general meeting, and auditors so appointed shall hold office until that meeting

Provided that—

(*a*) The company may at a general meeting of which notice has been served on the auditors in the same manner as on members of the company remove any such auditors and appoint in their place any other persons being persons who have been nominated for appointment by any member of the company and of whose nomination notice has

been given to the members of the company not less than seven days before the date of the meeting, and

(b) if the directors fail to exercise their powers under this sub section the company in general meeting may appoint the first auditors and thereupon the said powers of the directors shall cease (Section 132 (4))

From this clause it will be seen that the directors may appoint the first auditor before the first annual general meeting, but even in this case the shareholders have the power to remove such auditor and appoint another in his place, should they desire it The directors, when making the first appointment, are merely acting as agents for the shareholders who have not yet met as a body The auditor appointed by the directors acts for the shareholders in exactly the same way as if he were appointed direct by the shareholders

The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues the surviving or continuing auditor or auditors if any may act (Section 132 (5))

In this case again directors act for the shareholders and appoint an auditor to fill the casual vacancy, but when appointed the auditor is, as in all cases, the agent of the shareholders This subsection does not mean that the directors themselves may act as auditors during a vacancy, as is sometimes thought by students, but that they may appoint an auditor who must not be a director or officer of the company

The remuneration of the auditors of a company shall be fixed by the company in general meeting, except that the remuneration of an auditor appointed before the first annual general meeting, or of an auditor appointed to fill a casual vacancy, may be fixed by the directors, and that the remuneration of an auditor appointed by the Board of Trade may be fixed by the Board (Section 132 (6))

The remuneration of the auditors, in the same way as their appointment, rests entirely with the shareholders, except where, as a matter of convenience, the directors act for the shareholders in the case of the appointment prior to the first annual general meeting, and where a casual vacancy occurs, and even in these latter circumstances the appointment made, and remuneration fixed, by the directors only holds until the next annual general meeting, when the shareholders may refuse to re-appoint the nominee of the directors

It is commonly found that the resolution appointing the

auditors states that the fee is to be fixed by the Board At the Annual General Meeting of a company recently, this form of resolution was contested by a shareholder, as not being in accord with the Act If any shareholder objects to this form of resolution, it is considered that he is entitled to have the fee actually mentioned and decided by the Meeting It is open to question whether, if the remuneration is not fixed by the shareholders strictly in accordance with the Act, the auditors would be able to recover their fees if the company refused to pay The practice of leaving the fee to be fixed by the directors is a very common one, and it would seem that there is little practical risk in wording the resolution in this way, unless and until objection is taken by the shareholders

None of the following persons shall be qualified for appointment as auditor of a company—

(a) A director or officer of the company,

(b) except where the company is a private company, a person who is a partner of or in the employment of an officer of the company,

(c) a body corporate (Section 133 (1))

The principles underlying the provisions of the Act are that an auditor shall be in an independent position, and therefore no director or officer of the company can be appointed

It was not uncommon in the past to find one partner of a firm of accountants acting as director or secretary of the company, and for another partner or clerk in the employ of the accountants to act as auditor In these circumstances the auditor might find himself in conflict with his partner or principal, who was a director of the company The provisions of this section, therefore, make such appointments illegal in the case of public companies, but they are still permissible in the case of private companies

It will be observed from the section that no body corporate, for example, a limited liability company, can act as auditor of a company The section, however, provides that a body corporate, appointed before the 3rd August, 1928, shall not be disqualified from acting as auditor

Powers and Duties of Auditors

The powers and duties of auditors are defined by Section 134 of the Companies Act, 1929, the terms of which are of the utmost importance

Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of the auditors (Section 134 (2))

This subsection definitely gives the auditor the right of access to the books, accounts and vouchers of the company at all times, and "books" will include all statistical and memorandum books, such as Minute Books, Cost Books, Stock Books, Share Ledgers, etc Further, "vouchers" will include all documentary evidence that the auditor may require, such as contracts, correspondence, invoices, etc In addition to his right of access to the books, etc, the auditor is entitled to require from the directors and officers of the company information and explanations upon any points, therefore, it will be seen that he is not confined to the books, but where the books and vouchers are not clear, he can call for explanations Subsection (1) provides that if information is withheld, the auditor must report to the shareholders that he has not obtained all the information and explanations that he has required The auditor's powers in this direction are very complete and strong, and are carefully defined in the Act

The auditors of a company shall be entitled to attend any general meeting of the company at which any accounts which have been examined or reported on by them are to be laid before the company and to make any statement or explanation they desire with respect to the accounts (Section 134 (3))

This right to attend meetings was first introduced in the Act of 1928, before which the auditor had no statutory right to attend general meetings The effect of this subsection is to increase considerably the auditor's powers, as it will be seen that he is entitled to make any statement or explanation that he may desire at the meeting in connexion with the accounts

The auditors shall make a report to the members on the accounts examined by them, and on every Balance Sheet laid before the company in general meeting during their tenure of office, and the report shall state—

(a) whether or not they have obtained all the information and explanations they have required, and

(b) whether, in their opinion, the Balance Sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of

the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company (Section 134 (1))

It will be noted that the auditors have to make a report upon every Balance Sheet submitted to the shareholders in general meeting during their tenure of office, and that such report is addressed to the shareholders, and not to the directors If the auditor is not satisfied upon any points, or there is any information that, in his opinion, should be placed before the shareholders, he must qualify his report accordingly, and make any such matters clear therein

It is the duty of the directors to prepare the accounts, and the auditor cannot alter such accounts in any way, if dissatisfied upon any point, his duty is confined to dealing with the matter in his report, and thus laying the true facts before the shareholders In the same way, if the system of book-keeping is bad, the auditor cannot insist upon alterations, but if it is so bad that reliable accounts cannot be prepared, then, in such circumstances, he should report to this effect to the shareholders

The following is the form of report recommended by the Council of the Institute of Chartered Accountants in England and Wales—

REPORT OF THE AUDITORS TO THE SHAREHOLDERS OF LIMITED

We have audited the Balance Sheet of the Limited, dated the day of and (here identify it as "above set forth")

We have obtained all the information and explanations we have required

In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of our information and the explanations given us and as shown by the books of the company

The Act gives the auditor the fullest powers in order to be able to carry out a proper audit, and Sections 129 and 130 give shareholders and debenture-holders every opportunity to see the auditor's report

In the case of *Re Allen Craig & Co (London) Ltd and*

Re Companies Act, 1929 (*The Accountant*, Vol XC, page 424) the reports of the auditors had not been communicated to the shareholders and it was argued that in these circumstances the auditors should have communicated direct with the shareholders It was held, however, that the auditors' duties had been discharged when their reports were delivered to the company In this case the directors did not summon shareholders' meetings, so that the Balance Sheets and auditors' reports in question were never submitted to the shareholders It was held that it was the duty of the directors to summon the shareholders' meeting and to see that the report of the auditors was read at the meeting If meetings were not convened then it rested with the shareholders to insist upon the requirements of the statute being complied with

Qualifications in Auditors' Reports

In those cases in which an auditor has decided that he must make reservations in his report, the choice of the wording of the qualifications is a matter of vital importance It is a serious matter for any board of directors to be compelled to issue a Balance Sheet with a qualified report from its auditors The strongest pressure probably will be directed towards persuading the auditor to give a clean report, an invariable argument being that a qualified report will have a serious effect upon the affairs of the company and this may well be the case The auditor will be fully aware of this fact, but the whole purpose of his appointment is that he shall report to the shareholders in clear terms if he is not satisfied that the Balance Sheet exhibits a true and correct view of the state of the company's affairs

If an auditor has definitely decided that he must qualify his report, the directors, in most cases, will endeavour to persuade him to adopt wording that will soften the qualification This course is fraught with great danger as it is exactly in these circumstances that it is imperative that the auditor should make the position, as he sees it, absolutely clear to the shareholders In fact, that is the whole purpose of his office

In this connexion the *London & General Bank* case (see

pages 218–220) should be closely studied In this case the auditor qualified his report with the words "the value of the assets as shown on the Balance Sheet is dependent upon realization" His Lordship in his judgment pointed out that "it is a mere truism to say that the value of loans and securities depends upon their realization" The same might be said if an auditor worded his report to the effect that *subject to* the value of a specified asset "the Balance Sheet is properly drawn up so as to exhibit a true and correct view, etc" The position shown by every Balance Sheet is *subject to* the valuation of the whole of the assets of the company

In this connexion also the *Royal Mail Steam Packet* case should be studied In that case the auditor had insisted upon the words "adjustment of taxation reserves" being included in the wording describing the year's profits (See pages 240–248) His Lordship referred to these words as "those mystic words which are said to be so clear but which may or may not be clear"

In the *London & General Bank* case His Lordship defined the position with great clarity when he said "A person whose duty it is to convey information to others, does not discharge that duty by giving them so much information as is calculated to induce them, or some of them, to ask for more Information and means of information are by no means equivalent terms an auditor who gives shareholders means of information instead of information in respect of a company's financial position, does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty"

Under Section 134 (1) of the Companies Act, 1929, the auditor is required to state in his report to the shareholders whether, in his opinion, the Balance Sheet does exhibit a true and correct view of the state of the Company's affairs The established practice in the profession is for the auditor to include qualifications in his report to the shareholders and to conclude with such wording as "*subject to the foregoing remarks*, in my opinion, the above Balance Sheet is properly drawn up so as to exhibit a true and correct view, etc"

Provided that the wording of the reservations is explicit,

then no doubt the auditor will have made the position of affairs quite clear to the shareholders If, however, the points on which the auditor finds it necessary to make reservations are so many or so important as to render the Balance Sheet quite misleading, then it probably would be wise for the auditor to consider whether he should not state that in his opinion, "the above Balance Sheet is not properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs, etc "

An auditor is placed in a very difficult position when he finds it necessary to make reservations in his report to the shareholders It is, however, imperative that he should choose a form of wording that is as explicit as possible, as serious risks are entailed by the adoption of an ambiguous form of wording If the auditor feels grave doubt, as he well may in some cases, it will be wise for him before signing his report to take the best legal advice

Annual Return

Section 108 of the Companies Act, 1929, provides that every company shall once at least in every year make a return containing a list of all persons who, on the fourteenth day after the first, or only, ordinary general meeting in the year, are members of the company, and of all persons who have ceased to be members since the date of the last return, or, in the case of the first return, of the incorporation of the company This return contains various particulars as regards the share capital of the company, the amount called up and paid up on the shares, the total amount of calls unpaid, and various other particulars

This annual return must be contained in a separate part of the Register of Members, and a copy signed by the manager or secretary of the company must be forwarded to the Registrar of Companies

Except in the case of private companies, the annual return must include a written copy, certified by a director, manager, or secretary of the company to be a true copy of the last audited Balance Sheet, including every document required by law to be annexed thereto, together with a copy of the auditor's report These provisions are contained in Section 110 of the Companies Act, 1929, and

represent an alteration of the law effected by the Act of 1928

Previously a statement in the form of a Balance Sheet had to be included in the annual return, but, as will be seen, the 1928 Act substitutes the audited Balance Sheet of the company, so that in this way, with all public companies, the audited Balance Sheet and the auditor's report are available to the public, as the return including the Balance Sheet and auditor's report is contained in the company's file with the Registrar of Companies It will be observed, however, that this provision does not apply to private companies, and therefore the Balance Sheets of these companies are not available to the public

The Statutory Meeting and Report

Section 113 (1) of the Companies Act, 1929, provides as follows—

> Every company limited by shares and every company limited by guarantee and having a share capital shall, within a period of not less than one month nor more than three months from the date at which the company is entitled to commence business, hold a general meeting of the members of the company, which shall be called "the statutory meeting"

The directors shall, at least seven days before the meeting, forward a report called "the statutory report," to every member of the company, and this report is to be certified by the directors and a copy thereof has to be filed with the Registrar of Companies

The provisions of subsection (3) of the Section 113 are as follows—

> The statutory report shall be certified by not less than two directors of the company, or where there are less than two directors, by the sole director and manager, and shall state—
>
> (*a*) the total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted,
>
> (*b*) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid,
>
> (*c*) an abstract of the receipts of the company and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout,

and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company

(d) the names, addresses and descriptions of the directors, auditors if any, managers if any, and secretary of the company, and

(e) the particulars of any contract the modification of which is to be submitted to the meeting for its approval together with the particulars of the modification or proposed modification

Before the Companies Act, 1928, the statutory report included an abstract of the receipts and payments of the company on capital account It will be seen from (c) above that the abstract now must include all receipts and payments, that is to say, both capital and revenue

Section 113 (4) provides—

The statutory report shall so far as it relates to the shares allotted by the company and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, be certified as correct by the auditors, if any of the company

This will necessitate a complete audit of the share books of the company—which is described in detail in Chapter IX—and also the complete vouching and checking of the Cash Book in order that the abstract of receipts and payments may be verified Upon completion the auditor must sign his certificate, which is as follows—

I hereby certify that so much of this report as relates to the shares allotted by the company and to the cash received in respect of such shares and to the receipts and payments of the company on capital account is correct

The statutory meeting and report are not required in the case of a private company (Section 113 (10))

Underwriting Commissions and Commissions on Placing Shares

Section 43 of the Companies Act, 1929, gives the company power to pay underwriting commissions and commissions on placing or procuring subscriptions for shares, provided that payment of such commission is authorized by the Articles, that the commission paid does not exceed 10 per cent of the price at which the shares are issued, or the amount or rate authorized by the Articles, whichever is the less, and that the amount or rate per cent of the commission is disclosed in the prospectus, or, in the case of shares not offered to the public, in the statement in lieu of prospectus

"Underwriting shares" means that, upon an issue of shares to the public, certain persons enter into contracts with the company that, in the event of the public not subscribing for the whole of the issue, they, the underwriters, will subscribe for and take up the remaining shares. For example, suppose the case of a company making an issue of 100,000 £1 shares to the public, the whole issue being underwritten by various individuals who were entitled to an underwriting commission of 5 per cent upon the shares underwritten by each—if the public applied for, say, 60,000 shares, the underwriters would have to take up the remaining 40,000 shares between them *pro rata*. The commission paid to them is for taking this risk, and it is payable whether they actually have to take up shares or not. The auditors must see that any underwriting commission is properly authorized by the Articles, and has been disclosed in the prospectus, they must also inspect the underwriting contract with each underwriter, and see that the underwriters take up the remaining shares if the issue is under-subscribed. Commissions for placing shares are paid to persons who introduce subscribers, in which case the person claiming the commission should initial or mark the application letter of the subscriber, and the auditors should examine the marked application letters and thus check the commission payable. Companies have always been entitled to pay a brokerage upon shares, that is, an amount payable per share to stockbrokers and agents whose clients subscribe for shares. Such brokerages should only be paid if the application letters bear the brokers' stamp, and the auditor must, therefore, examine the stamped application forms. These payments of brokerage are not subject to the provisions of Section 43.

> Where a company has paid any sums by way of commission in respect of any shares or debentures, or allowed any sums by way of discount in respect of any debentures, the total amount so paid or allowed, or so much thereof as has not been written off, shall be stated in every Balance Sheet of the company until the whole amount thereof has been written off. (Section 44 (1).)

This section provides that if any commissions in respect of shares or debentures are paid, and the total amount is not written off to Profit and Loss Account at once,

but is spread over a period, the amount carried forward must be shown as a separate item in the Balance Sheet The same applies if debentures are issued at a discount, the total amount of the discount must be treated in the same way The auditors must see that the terms of this section are complied with, and, therefore, these commissions or discounts upon debentures must not be included under the heading of preliminary expenses, but must be shown separately in the Balance Sheet

Payment of Interest to Shareholders During Construction

Section 54 of the Companies Act, 1929, gives power, in certain circumstances, to pay interest out of capital to shareholders during construction The first part of the section reads as follows—

Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is for the time being paid up for the period and subject to the conditions and restrictions in this section mentioned, and may charge the sum so paid by way of interest to capital as part of the cost of construction of the work or buildings, or the provision of plant

Suppose, for example, the case of a company formed to carry on a manufacturing business, the factory having to be erected first Until the factory is completed, the company cannot trade or earn profits, and, therefore, there can be no possibility of paying dividends to the shareholders upon their capital In such circumstances, this section provides that, upon the capital advanced by the shareholders specially for this purpose, they can receive interest during the period of construction, and such interest can be paid provided that the terms of this section are complied with The interest thus paid is paid out of capital and is debited to the Building Account, as part of the cost of construction The provisions that have to be complied with are as follows—

(1) No such payment shall be made unless the same is authorized by the Articles or by special resolution

(2) No such payment, whether authorized by the Articles or by special resolution, shall be made without the previous sanction of the Board of Trade

(3) Before sanctioning any such payment the Board of Trade may, at the expense of the company, appoint a person to enquire and report to them as to the circumstances of the case, and may before making the appointment, require the company to give security for the payment of the cost of the inquiry

(4) The payment shall be made only for such period as may be determined by the Board of Trade, and such period shall in no case extend beyond the close of the half-year next after the half year during which the works or buildings have been actually completed or the plant provided

(5) The rate of interest shall in no case exceed[1] four per cent per annum or such other rate as may for the time being be prescribed by Order in Council

(6) The payment of the interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid

(7) The accounts of the company shall show the share capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate

It will be seen from the above that there are very stringent regulations governing this matter, and that such payments of interest out of capital are controlled by the Board of Trade

In cases where interest is paid in this way, an auditor must see that all the provisions of Section 54 have been complied with

Statutory Books

Every company registered under the Companies Act, 1929, must keep the following books—

(1) REGISTER OF MEMBERS (Section 95 of the Companies Act, 1929), in which must be entered the names, addresses, and occupations of all the members of the company, the shares held by each, the distinguishing numbers, and the amount paid or agreed to be considered as paid on such shares, also the dates at which each person was entered in the register, and the date at which any person ceased to be a member Under Section 110 (1), in a separate part of the Register of Members, the annual list of members and summary has to be entered

Every company having more than fifty members shall, unless the Register of Members is in such a form as to constitute in itself an index, keep an index of the names of the members of the company The index, which may be in the form of a card index, shall in respect of each member

[1] By Order in Council the present rate allowed is 6 per cent per annum

contain a sufficient indication to enable the account of that member to be readily found in the Register

The Register of Members is open to the inspection of any member gratis, and to the inspection of any other person on payment of a fee not exceeding 1s for each inspection (Section 98)

(2) MINUTE BOOK (Section 120, Companies Act, 1929), in which must be entered minutes of all proceedings at every meeting of the shareholders and directors or managers of the company

(3) REGISTER OF DIRECTORS (Section 144 of the Companies Act, 1929) Every company shall keep at its registered office a register of its directors or managers, containing particulars in the case of each individual as to his present Christian names and surname, any former Christian names or surname, his address, nationality, and if that nationality is not the nationality of origin, his nationality of origin, his business occupation, if any, etc In the case of a corporation, its corporate name and registered or principal office A copy of such register has to be sent to the Registrar of Companies The register shall, during business hours, be open to the inspection of any member of the company, without charge, and to any other person on payment of 1s or such less sum as the company may prescribe, for each inspection

(4) REGISTER OF CHARGES (Section 88, Companies Act, 1929) In this register must be entered particulars of every mortgage or charge specifically affecting the property of the company, giving in each case a short description of the property charged, the amount of the charge, and, except in the case of securities to bearer, the names of the persons entitled thereto The register is open to the inspection of any creditor or member of the company, without fee, and to any other person on payment of a special fee not exceeding 1s for each inspection

Redeemable Preference Shares

In accordance with the terms of Section 46 of the Companies Act, 1929, a company, if authorized by its Articles, may issue redeemable preference shares, such shares to be

shown separately on every Balance Sheet, with particulars of the date on or before which they are liable to be redeemed No such shares shall be redeemed unless they are fully paid, and they must be redeemed out of the profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of redemption If redemption takes place out of the profits, the amount of profit used must be transferred to a Capital Redemption Reserve fund For the purposes of reduction of share capital, this fund will be treated as part of the paid up share capital of the company In other words, this fund will not be available for payment of dividends It may, however, be applied in paying up unissued shares of the company to be issued as fully paid bonus shares

Issue of Shares at a Discount

In accordance with the terms of Section 47 of the Companies Act, 1929, a company may issue shares of a class already issued at a discount under the following conditions—

(*a*) The issue must be authorized by resolution in general meeting and sanctioned by the Court

(*b*) The resolution must specify the maximum rate of discount at which shares are to be issued

(*c*) Not less than one year must, at the date of issue, have elapsed since the date on which the company was entitled to commence business

(*d*) Shares to be issued at a discount must be issued within one month after the date on which the issue is sanctioned by the court or within such extended time as the court may allow

Where a company has issued shares at a discount it will be compelled to show the amount of the discount separately on every subsequent Balance Sheet or prospectus until the whole of the discount has been written off

Prohibition of Provision of Financial Assistance by a Company for Purchase of its Own Shares

By the terms of Section 45 of the Companies Act, 1929, a company is prohibited from directly or indirectly assisting

any person financially, either by means of loans, or otherwise, in the purchase of shares in the company except in connexion with the purchase of shares by or for the benefit of employees In the latter case the aggregate amount of outstanding loans for such purposes must be shown as a separate item on the Balance Sheet

Power to Re-issue Redeemed Debentures

Subject to the provisions of Section 75 of the Companies Act, 1929, a company has power to re-issue redeemed debentures, and where a company has power to re-issue redeemed debentures particulars with respect to the debentures which can be so re-issued must be stated in every Balance Sheet of the company

Prospectus

Part II of the Fourth Schedule of the Companies Act, 1929, provides that every prospectus must contain a report by the auditors as to the profits made by the company in each of the three preceding years and the rates of dividend paid on all classes of shares for the same period Where a company has been in existence for less than three years the report must cover the whole period

If the proceeds, or any part of the proceeds, of an issue of shares or debentures are to be applied in the purchase of an established business, the prospectus must contain a report by accountants showing the profits of that business for each of the three years preceding the issue of the prospectus

Certificates of Profits in Prospectuses

The making of a report as to past profits for prospectus purposes involves considerable responsibilities and, therefore, requires very careful consideration

On no account must an average figure only be given in the auditors' report, as it will be observed that the Act provides that "the profits of the company in respect of *each* of the three financial years," etc , shall be stated in the report

The figure of profit for any year given in this report will rarely agree with the net profit figure shown by the

audited accounts, as adjustments have to be made for prospectus purposes All abnormal items on both sides of the Profit and Loss Accounts have to be eliminated in order that a true view may be obtained as to what the normal earnings have been

For example there will be eliminated from the accounts items of expenditure or charge that will not arise under the new constitution of the undertaking such as interest upon loans, etc , that will be paid off, rent of premises that will be purchased, exceptional and non-recurring losses or charges such as a loss through fire not covered by insurance In the same way any exceptional profits will be eliminated, such as a profit upon the sale of capital assets, and income from assets not taken over

Under the new constitution the administrative officials may be paid upon an entirely different basis If so the salaries, etc , paid in the past will be eliminated

Depreciation of fixed assets as charged in the accounts is, as a rule, eliminated These assets are commonly taken over upon the basis of a revaluation The depreciation charges in the future, therefore, will be calculated upon the basis of the revaluation figures The profits for each year should therefore be shown exclusive of depreciation and the report should state what the annual charge for depreciation is estimated to be in the future upon the basis of the revaluation

The whole object of the report upon profits is to give a fair idea as to what the future earnings are likely to be For this purpose the profits for the three preceding years are taken, but they must be adjusted in respect of known changes in the future conditions and circumstances On no account should an auditor be a party to giving an estimate of future profits, the directors may do that but an auditor—never, he must confine his report to ascertained results as per the Profit and Loss Accounts of the past, adjusted upon the lines indicated above

Provisions as to Liability of Auditors

As a direct result of the City Equitable Case, which is dealt with in Chapter XII, Section 152 of the Companies Act, 1929, provides that if the Articles of a company, or

any contract, exempt an auditor or directors from liability for negligence or breach of duty in relation to the company, the provisions of such Articles shall be void In the City Equitable Case it was held that the auditors and the directors were protected by such a clause in the Articles of that company

The auditor is, however, given a certain amount of protection by Section 372 of the Companies Act, 1929, as it is provided that the court has power to grant relief in cases where there is no suggestion of dishonesty or unreasonable conduct Previous to the 1928 Act these provisions applied only to directors, but they now also apply to auditors

CHAPTER IX

SPECIAL POINTS IN CONNEXION WITH THE AUDIT OF COMPANIES UNDER THE COMPANIES ACT, 1929

THE principles of auditing apply to all audits, but in connexion with companies under the Companies Act, 1929, there are some special points which must be dealt with here, as the audit of these companies forms such a preponderantly large proportion of the audit practices of accountants, that no book on auditing would be complete without some more or less detailed reference to the audit of these concerns

Memorandum of Association

Every company limited by shares must have a Memorandum of Association, stating—

(1) The name of the company, with "limited" as the last word in its name

(2) The situation of the registered offices of the company

(3) The objects of the company

(4) That the liability of the members is limited

(5) The amount of share capital with which the company proposes to be registered, and the division thereof into shares of a fixed amount

The most important of these from an auditor's point of view is No 3, for the objects clause must set out exactly the purposes for which the company is formed, and the nature of the business that it is intended to carry on, and a company has no power to enter into any transaction that does not come within the terms of its objects clause This clause is always made as wide as possible, but an auditor must see that the company does not break the provisions thereof and enter into *ultra vires* transactions

The terms of the Memorandum cannot be altered, except by complying with certain provisions in the Act, and considerable restrictions are placed in the way of such alterations Important ones, such as a reduction of

capital, or alteration of the objects of the company, require the sanction of the Court, and shareholders, debenture holders and creditors, who may be affected by the alterations, are entitled to place their views before the Court

The Memorandum of Association may be said to govern the external affairs of a company, and every clause is of interest and importance to all persons entering into business relations with a company

Articles of Association

A company need not have a special set of Articles, and the Companies Act, 1929, contains a model set of Articles known as Table A, which govern all companies for which special Articles have not been drawn up But, upon formation, a company may exclude the whole or parts of the provisions of Table A, and substitute therefor its own specially drawn Articles An auditor must see whether Table A, or parts thereof, have been thus excluded, for he must be familiar with the exact regulations that govern the particular company

The Articles of Association govern the internal affairs of the company, and an auditor must see that the terms thereof are complied with The Articles can be altered at any time by a special resolution of the shareholders The following are examples of matters that are governed by the terms of the Articles—

The rights of shareholders *inter se*

Calls on shares

The forfeiture of shares on account of the non-payment of calls

Alterations of capital

The appointment of a managing director

The appointment of directors

The powers and duties of directors

The declaration of dividends

The accounts and audit

The borrowing powers

The payments of underwriting commissions, and com missions on placing shares

The payment of interest out of capital during construction

Examination of Legal Documents Prior to the Commencement of the Audit of a Company

Before commencing the audit of a company, an auditor should examine carefully the Memorandum and Articles of Association, and he should make notes in his audit note-book of all important provisions, with the terms of which he must be familiar while conducting his audit. In the same way, if one has been issued, he should examine the prospectus which will disclose the amount of Share Capital issued, the terms of the issue, the amount of the minimum subscription, any underwriting commission payable, an estimate of the amount of the preliminary expenses and the terms of all material contracts. He should also examine the contract of sale (if any) with the vendors, and from the latter he will ascertain the purchase price, particulars of the assets that are being acquired, the amount (if any) paid for the goodwill of the business, and the liabilities (if any) that are being taken over. It then must be seen that the opening Journal entries are correct and in accordance with the contract, and also that the various terms of the latter are carried out. In the case of a continuing company, the previous year's Balance Sheet and auditor's report should be examined.

Share Capital

The share capital of a company is often divided into preference and ordinary shares, and the rights of the respective shareholders are governed by the terms of the Articles. The preference shares, as a rule, are entitled to a fixed dividend out of the profits, the surplus profits after the payment of the dividend on the preference shares belonging to the ordinary shareholders. It depends upon the terms of the Articles whether the preference shares also carry a preferential right as regards capital, that is to say, whether, in the event of liquidation, the preference shareholders are entitled to the return of their capital before there is any return on the ordinary shares. The Articles must expressly provide that the preference shares are to be preferential as to capital, otherwise they rank equally with the ordinary shares in this respect. The preference shareholders' rights to dividend may be either cumulative

or non-cumulative, if cumulative, it means that in the event of there not being sufficient profits in any year to pay the preference dividend, such arrears have to be made up in any future years when the profits are sufficient, and thus there can be no dividend paid upon the ordinary until all such arrears upon the preference shares have been paid If non-cumulative, the preference shareholders are entitled to a fixed dividend out of the profits of each year, and if such profits are insufficient, then there is no right to make up shortages out of the surplus profits of future years All preference shares are cumulative, unless the Articles specially provide that they shall be non-cumulative In some cases the preference shareholders participate in any surplus profits, after, as a rule, a certain rate of dividend has been paid upon the ordinary shares Such shares are known as participating preference shares

Issue of Shares

In the ordinary course, the first step in the raising of share capital is the issue of a prospectus inviting applica tions for shares, such prospectus being advertised in newspapers, and circulated through stockbrokers, bankers, solicitors and others connected with or interested in the company As a rule, applications for shares have to be sent in on special forms direct to the company's bankers, accompanied by a deposit, the banker sending the applicant a receipt therefor These applications are numbered and entered in an Application and Allotment Book, and in due course are considered by the directors, who then allot shares to the applicants If more shares have been applied for than are being issued according to the prospectus, the directors make a selection and they may refuse certain of the applications, notice of this fact being sent to the applicant by means of what is known as a "Letter of Regret," and at the same time the deposit paid is returned In other cases, where there is an over-subscription, the number of shares applied for by individual subscribers is reduced proportionately, and allotments made accordingly, the amount over-paid upon application, as a rule, being applied in reduction of the further amounts due in respect of the shares The allotment is made by the directors

passing a minute to this effect, and sending to each applicant an "Allotment Letter," notifying the number of shares allotted and the amount due on allotment The posting of the Allotment Letter concludes the contract between the company and the individual shareholder, for this reason the Allotment Letter must be stamped with a sixpenny Contract Stamp The balance due upon the shares either has to be paid up on certain dates specified in the prospectus, or is called up as and when the directors require the money—in which latter case a minute is passed by the board making the call, and notices are sent to all shareholders In due course, when the share certificates have been made out for each shareholder, these are issued in exchange for the Allotment Letter and the banker's receipts for the instalments paid to date

Audit of the Share Books upon an Issue of Shares

The audit of the Share Books upon an issue of shares should be conducted as follows—

(1) Check the application letters with the Application and Allotment Book

(2) Check the Share Cash Book with the Pass Book

(3) Check amounts received from subscribers from the Cash Book to the Application and Allotment Book

(4) Check minutes of allotment with the Application and Allotment Book

(5) Check "letters of regret" or carbon copies thereof with the Application and Allotment Book, and see that amounts paid on application are returned

(6) Check the distinctive number given to each block of shares

(7) Check the Application and Allotment Book to the Share Ledger, seeing that all details are entered correctly

(8) See that the total shares issued does not exceed the total authorized capital according to the Memorandum

(9) See that the minimum subscription upon which the company may proceed to allotment has been applied for No allotment of shares shall be made unless the amount stated in the prospectus as the minimum subscription has been realized (Part I, Fourth Schedule)

(10) Vouch the opening Journal entries in the financial books

(11) Check the balances on the Share Ledger to the schedule, seeing that the total agrees with the total number of shares issued

(12) If shares have been issued for consideration other than cash, see the contracts and the minutes adopting them, and ascertain that such contracts have been filed with the Registrar of Companies If certain of the vendors' shares are to be issued to their nominees, then the auditor should inspect the vendors' written authority for the issue of such shares to the nominees

(13) If the issue has been underwritten, see the contracts with the underwriters, and, if the issue is not fully subscribed, the directors' minutes allotting the balance of the shares to the underwriters Underwriters, as a rule, have to sign applications for the number of shares they underwrite—if so, these should be inspected Vouch the Journal entries

(14) If placing commissions and brokerages are paid, check the amounts paid with stamped or marked application forms Inspect the receipts from persons receiving such commissions and brokerages

(15) As a rule, the auditors are requested to check and initial the share certificates before they are signed and sealed by the directors

(16) Upon calls becoming payable, the detail amounts due will be entered in a Call Book, or in special columns in the Application and Allotment Book, and these entries will be checked in the same way as the allotment, that is, with the directors' minute, the Cash Book and Pass Book, and to the Share Ledger

(17) If the share certificates have been issued, the returned allotment letters and bankers' receipts should be checked with the Share Ledger

Transfer Audit

An auditor must audit the share books upon an issue of shares, and when calls are made, in order that he may satisfy himself that the whole of the money due has been accounted for In subsequent years, however, it is not

part of his duty to carry out a transfer audit, all that is necessary being that the balances upon the Share Ledger should be checked on to a list of balances, it being seen that the total thereof agrees with the total issued capital Auditors are often instructed to carry out transfer audits, but this is a matter of special arrangement, and one for which the auditor is entitled to a special fee The procedure at a transfer audit should be as follows—

(1) When transfers are received, the transferor should be notified immediately by the company, so that in this way fraudulent transfers may be detected If this system is in force, check the duplicate copies of such notices to the Transfer Register, and inquire as to whether any objections have been received

(2) Check transfers with the Transfer Register, seeing that transfers have been properly signed, witnessed and stamped, and check the distinctive numbers of the shares into the Register Thereafter, cancel the transfer with the auditor's audit stamp

(3) Verify a proportion of the signatures of transferors with previous transfers or application letters

(4) Check old certificates with transfers, and thereafter cancel the certificates

(5) Check entries in Transfer Register to the credit of the transferor's account in Share Ledger, seeing that he has the shares, and checking the distinctive numbers

(6) Check entries in Transfer Register to debit of transferee's account in Share Ledger

(7) Check and initial new certificates, and if transferor has not sold the whole of his shares, check and initial balance certificates issued to him

(8) At subsequent audits, see the directors' minute passing the transfers previously checked

Transfer Fees

Count the number of transfers, and see that the whole of the transfer fees have been accounted for

Debentures

Upon an issue of debentures, the allotment, etc , will be checked in exactly the same way as an allotment of shares

The auditor must see that the Articles give the directors power to borrow money in this way, and he should examine the directors' minute exercising that power The actual debenture or trust deed should be examined, in order that the exact terms of the issue may be ascertained It must further be seen that the charge given by the debentures upon the assets of the company is entered in the Register of Charges, in accordance with Section 88 of the Companies Act, 1929, and that the necessary particulars have been filed with the Registrar of Companies

The entries in the financial books should be checked, and if debentures are issued at a discount, the full nominal amount must be credited to the Debenture Account, as that is the actual amount of the liability that will have to be repaid, and the amount of the discount must be debited to a separate account If this discount is written off to Profit and Loss Account over a period of years, the amount carried forward must be shown as a separate item in the Balance Sheet to comply with the terms of Section 44 of the Companies Act, 1929 The discount upon debentures should be written off to revenue as soon as possible, but, subject to the provisions of the Articles of the particular company, an auditor could raise no objection if the discount were written off over the period of the debentures In cases where shares have been issued at a discount, the entries will be treated in the same way and the amount of the discount must be shown separately in the Balance Sheet (Section 47 (3))

If debentures are issued at a premium, the nominal amount of the debentures again must be credited to the Debenture Account, and the amount of the premium must be credited to a Premium on Debentures Account Shares may be issued at a premium, in which case the premium should be dealt with in exactly the same way Premiums upon shares and debentures should be utilized as additional working capital, and, therefore, transferred to reserve, or used to write down preliminary expenses, goodwill, or any fixed assets, but, on the other hand, unless there are express provisions in the Articles, there is nothing in the Companies Act to prevent such premiums being credited to Profit and Loss Account This latter is, however, an

unsound course to adopt, as such premiums are not an ordinary trading profit, and, in effect, if such sums were credited to Profit and Loss Account, and thus made available for dividend, if a dividend were paid it would amount to a return to the shareholders as dividend of amounts which they themselves had subscribed If premiums on shares or debentures were made available for dividend in this way, an auditor should see that the accounts made this fact quite clear

In the case of *Brown* v *Gaumont British Picture Corporation Ltd* the circumstances were that a payment of dividend had to be met largely out of General Reserve which had been mainly derived from the premium on shares issued Payment of this dividend was upheld (see page 211)

If debentures are issued at par and repayable at the end of a period at a premium, then they should appear in the books and on the Balance Sheet at the nominal amount, with a note that they are repayable at a certain date at a premium The premium is in the nature of a payment of deferred interest, and should be provided for out of revenue over the period of the debentures, as otherwise the whole amount of the premium will have to be charged to the Profit and Loss Account of the year in which the debentures are redeemed If a sinking fund is being created to provide for the redemption of the debentures, then it should include the premium To illustrate this, suppose the case of a company with debentures of £10,000 repayable at the end of ten years at a premium of 5 per cent, the Balance Sheet at the commencement of the period being as follows—

BALANCE SHEET

	£		£
Capital	15,000	Sundry Assets	25 000
Debentures (repayable at the end of ten years at 105)	10 000		
	£25 000		£25 000

A sinking fund is created to provide £10,500, the amount required, and the Balance Sheet at the end of the period would be as follows

BALANCE SHEET

	£		£
Capital	15 000	Sundry Assets	25 000
Debentures	10 000	Investments on account of	
Sinking Fund	10 500	Sinking Fund	10 500
	£35 500		£35 500

The Debenture Account now should be credited with £500, the amount of the premium payable, this amount being debited to the Sinking Fund Account If the investments realized cost, the exact sum required to pay off the debentures at the premium would be produced, and, after such repayment, the Balance Sheet would be as follows—

BALANCE SHEET

	£		£
Capital	15 000	Sundry Assets	25 000
Sinking Fund Account (now a general reserve of the company)	10,000		
	£25,000		£25,000

It will be seen that, although £10,500 has been provided over the period, only £10,000 remains upon the Sinking Fund Account after the repayment of the debentures The reason for this is that the £500 premium is a charge against the profits in exactly the same way as is the interest paid upon the debentures, and would have had to be charged against revenue in any event, but the provision of the £10,000 is an appropriation of profits and is a voluntary act by which profits available for distribution have been retained in the business and used to pay off a capital liability, or, in other words, the shareholders have invested £10,000 of their profits in the concern instead of withdrawing them, thus making the total amount owing to them by the business £25,000 instead of £15,000, the original capital

Debentures Issued as Collateral Security

Debentures may be issued to creditors of a company to secure loans and overdrafts For example, suppose the case of a company borrowing £7000 from its bankers,

and, as security for the repayment of this sum, issuing £10,000 debentures as collateral security In the Balance Sheet, the bank should be shown as creditors for the loan of £7000, and against this item should appear a note "in respect of which £10,000 debentures have been issued as collateral security" The position is that the primary liability of the company to the bank is the loan of £7000, and the debentures held by the bank are dormant, and no interest is paid thereon, but if the company defaulted, then the bank could take up the debentures and would rank as debenture-holders for £10,000, being entitled to their proportion of the security given to the whole debenture issue If a receiver were appointed for the debenture holders, who eventually paid 20s in the £, the bank would receive £10,000, out of which it would retain the loan of £7000, interest to date and costs, and return any surplus to the company

An auditor should see the loan agreement (if any) and the directors' minute issuing these debentures for this purpose, and he must see that the position is shown correctly in the Balance Sheet He should also ascertain that these debentures have been entered in the Register of Mortgages and Charges, and inquire as to whether the necessary particulars have been filed with the Registrar of Companies

Preliminary Expenses

Upon the formation of a company there are various initial expenses in connexion with the formation and the raising of the share capital that are debited to a Preliminary Expenses Account An auditor should refer to the contract with the vendors, if any, to see whether they have to bear the whole or any part of these expenses, and, if so, he must see that the company does not bear any expenses that are payable by the vendors

The auditor should carefully examine and vouch the items debited to this account, and thus satisfy himself that they are a proper charge to Preliminary Expenses Account Under this heading will be included, for example, the following—

LEGAL CHARGES in connexion with the preparation of

the Memorandum and Articles of Association, the prospectus and the contracts with the vendors, and these will be vouched by the production of the solicitors' receipted bill of costs,

COSTS OF PRINTING the Memorandum and Articles of Association, and the prospectus, which will be vouched by the production of the printers' receipted bill of costs,

COSTS OF ADVERTISING the prospectus, which will be vouched with the receipts from the newspapers, or, if done through an agent, with his receipted account,

STAMP DUTIES payable upon registration, which generally will be paid by the solicitors, and will, therefore, appear in their bill of costs The amount can be verified by an examination of the certificate of incorporation, upon which the duties paid are stated

REPORTS FROM ENGINEERS, ACCOUNTANTS, ETC, for prospectus purposes will be vouched with the receipted bills of costs

The preliminary expenses must appear as a separate item in the Balance Sheet (Section 124 (2)), and in order to comply with the Companies Act, 1929, must not include commissions paid for underwriting or placing shares, or discounts upon debentures The debit balance upon Preliminary Expenses Account should be written off to revenue over a short period of years, generally three to five years, but there is nothing in the Companies Act to compel this, though there may be provisions to this effect in the Articles

Profits and Losses Before the Date of Incorporation

When a company is formed to purchase and take over an existing business, the contract often provides that the purchase is to be completed upon the basis of the figures as at a certain agreed date, such date being before the actual incorporation of the new company, one of the terms of the contract being that the new company shall take the profits as from the agreed date For example, a company might be formed to take over a business upon the basis of a Balance Sheet at the 31st December, the new company being entitled to the profits as from that date, but the formation of the company might take some little

time, and the certificate of incorporation might not be received until (say) the following 1st of March In such circumstances, the intermediate profits, from the 31st December to the 1st March, represent capital and are not available for distribution as dividend The reason is that these profits are included in the purchase price In fixing the price, the vendors will have taken into account the fact as to whether the profits between the 31st December and the date of incorporation are to belong to them or to the purchasing company, if, as in this illustration, they are to belong to the latter, the purchase price will have been increased accordingly Therefore, these profits have been purchased and paid for by the new company, and if, when received, such profit were paid away as dividend, it would amount to a return to the shareholders of part of the capital they have themselves contributed

There is no express provision in the Companies Act upon this point, but Table A provides, as also do the majority of Articles of Association, that "No dividend shall be paid otherwise than out of profits" A company cannot earn profits prior to its coming into existence and therefore these profits must be regarded as capital

A difference of opinion exists as to exactly what date should be adopted for the purpose of apportioning the first year's profits, the various dates being (*a*) the date of incorporation, (*b*) the date when a public company obtains the certificate entitling it to commence business, and (*c*) the date when the company actually adopts the agreement of sale The date most commonly adopted in practice is the date of incorporation, but, in the author's opinion, the date when the company adopts the agreement of sale is the correct date

If, as is customary, no accounts are taken at the date of incorporation, it is necessary to calculate the amount of the profits that have to be treated as capital If, for example, in the case above, the next accounts were prepared at the following 31st December, the better method would be to apportion the full year's profit between the two periods, before and after the 1st March, on the basis of the turnover for these two periods For the purpose of this apportionment adjustment must be made for the exceptional

items falling within each of these two periods, such as directors' fees, debenture interest, and other expenses incidental to the company's formation, and, on the other hand, items connected solely with the previous owners' management, such as salaries and expenses paid to them during the period prior to the company taking over the undertaking Another method is to apportion on the basis of time, that is to say, in this case, that two months out of the twelve are before incorporation, therefore, one-sixth of the full year's profit is capital, but, as the profits earned in different periods of a year may vary considerably, this method, in many cases, is not a good one to adopt In the case of a business when monthly Profit and Loss Accounts are prepared, the allocation of the year's profit as between the two periods would present no difficulty The proportion of the full year's profit that is fixed as being before the date of incorporation or the date when the agreement for sale was adopted, should be transferred from Appropriation Account to the credit of a Capital Reserve Account, or used to write down preliminary expenses or goodwill If any interest is paid to the vendors upon the purchase money, the interest for the period before the date of incorporation, or the date when the agreement for sale was adopted, should be debited against the profits before that date, and any interest for the period after that date should be debited to Profit and Loss Account

In the above circumstances, an auditor should examine the whole facts most carefully, and see that the profits before the date of incorporation, or the date when the agreement for sale was adopted, are ascertained as accurately as possible, and are not made available for dividend or used for revenue purposes

For like reasons, if a loss is incurred before the date of incorporation, such loss is a capital loss and may be treated as such in the accounts of the company The amount of the loss before the date of incorporation should be ascertained in exactly the same way as is explained above in connexion with profits The amount of the loss before the date of incorporation is generally debited to Capital Reserve, if such Reserve exists, or added to Goodwill

Calls in Arrear

If any calls have not been paid, a debit balance will appear upon the Call Accounts in the General Ledger, and the details making up these balances will be ascertained by reference to the Share Ledger These unpaid calls should be brought to the notice of the directors by the auditor, who should see that the total thereof is shown as a deduction from the issued capital in the Balance Sheet

Calls Paid in Advance

Any calls paid in advance should appear to the credit of a special account, or as credit balances upon Call Accounts, and the auditor should verify the details making up the total by reference to the Share Ledger The total of the calls paid in advance should appear as a separate item in the Balance Sheet

Forfeited Shares

Shares may be forfeited for non-payment of calls, if express power to this effect is contained in the Articles In cases where shares are forfeited in this way, an auditor must see that the Articles give the directors this power, and, further, that the provisions of the Articles have been carried out as regards giving the defaulting shareholder proper notices The minute of the directors forfeiting the shares must be inspected, and it must be seen that the correct entries have been made in the financial books to record this transaction, and that the Share Ledger has been adjusted accordingly The amount called up upon the shares forfeited must be debited to Share Capital Account and credited to a Forfeited Shares Account, and the debit balances upon the Call Accounts, which represent the calls due upon these shares but unpaid, should be written off to the debit of the Forfeited Shares Account, the latter account will then show a credit balance equalling and representing the amount paid up upon the shares forfeited If these shares are re-issued at a discount, which can be done provided the discount does not exceed the amount already paid upon the shares by the old shareholder, any such discount should be debited to the

Forfeited Shares Account, and if, thereafter, this account shows a credit balance, this represents the final profit upon the forfeiture, which profit should be transferred to general reserve, or used to write down preliminary expenses or fixed assets But there is nothing in the Companies Act to prevent this profit being credited to Profit and Loss Account, subject, of course, to any restrictions provided in the Articles of the particular company If, at the date of the Balance Sheet, the shares have not been re-issued, the auditor should see that the credit balance upon the Forfeited Shares Account is shown as a separate item in the Balance Sheet, being described as "amounts paid up upon shares forfeited"

Directors' Fees

As regards the vouching of directors' fees, the Articles should be inspected and the provisions thereof carefully noted The amount of the fees may be fixed by the Articles, or it may be left to the shareholders to vote the amount, in which latter case the shareholders' minute should be examined On the other hand, directors are sometimes paid by the attendance, in which case the Directors' Attendance Book must be inspected, and the number of attendances of each director counted The auditor should also examine the Register of Directors and Managers, to ascertain who are the directors of the company, and he should then see that each director receives only the amount properly due to him Receipts should be obtained, though endorsed cheques only are sometimes produced to the auditor, and if the signatures are known, these are sometimes considered sufficient

If the income tax upon the directors' fees has been paid by the company, such tax must be deducted from the fees when paying the directors, though nowadays the directors are generally assessed for income tax direct in respect of their fees, in which case the company pays the fees in full. The income tax upon directors' fees must never be borne by the company, unless the shareholders have voted the fees free of tax, and the total of the fee, plus the tax, is within the maximum fee (if any) provided for by the Articles

Fees accrued but unpaid at the date of the Balance Sheet, must be provided for Sometimes, in bad years, an auditor is informed that the directors have agreed to waive their fees, but even in these circumstances the auditor must insist upon such fees being either included in the accounts or referred to in his report, unless all the directors have voted upon and signed a minute or memorandum, by which they all mutually agree to renounce formally all claim to their fees for the period of the accounts, otherwise, an agreement under seal with each director would be necessary The auditor must, therefore, see that these requirements have been complied with

If the directors are entitled to a percentage of the profits, the auditor should inspect the provisions of the Articles, by virtue of which such percentage is paid, and he should also see that the percentage is correctly calculated

The total amount of the remuneration, emoluments, etc , paid to the directors, including amounts received from subsidiary companies, must be stated in the accounts, as also must loans to directors and officers of the company The provision as regards remuneration paid to directors does not apply to a managing director of the company In the case of any other directors who hold any salaried offices or employment in the company all that has to be disclosed in the accounts is the sum paid to them by way of directors' fees (Section 128)

Section 148 provides that if the members of the company holding one-fourth of the aggregate number of votes make demand in writing to that effect, then the directors shall furnish to all members of the company a statement certified by the company's auditors, showing as respects each of the last three preceding years the aggregate amount of remuneration or other emoluments received by the whole of the directors of the company, including the managing director and directors holding service agreements This aggregate shall include amounts received by directors from subsidiary companies, and any income and sur-tax paid by the company in respect of the remuneration or emoluments of directors Any director who fails to comply with the provisions of Section 148 is liable to a fine not exceeding fifty pounds

Directors' Expenses

Directors are not entitled to their travelling expenses to attend board meetings, unless expressly allowed by the Articles, but they are entitled to proper expenses if travelling upon the business of the company, and in this latter case they should produce vouchers, and it is advisable that the amounts paid to them, if substantial, should be passed at the board meetings The auditor, therefore, should inspect the receipts and the directors' minutes, and satisfy himself that the expenses appear to be reasonable

Managing Director's Remuneration

The Articles must give power to appoint a managing director, and such power is generally vested in the directors, who also fix the remuneration payable The auditor must, therefore, inspect the Articles, and the minute of the directors, seeing that the remuneration paid is in accordance therewith If there is a contract with the managing director, this should be inspected

Minute Books

It is most important that an auditor should inspect both the directors' and the shareholders' Minute Books, for the minutes are the only authority for many of the transactions of a company, and, apart from this, by reading the minutes, an auditor often becomes aware of important matters that are taking place, and which should be provided for in the accounts, such as pending litigation in connexion with disputed claims

The following are examples of matters for which the shareholders' minutes are the authority—

Passing and adoption of the accounts
Transfers to general and other reserves
Declaration of dividends
Appointment and remuneration of directors
Appointment and remuneration of auditors
The alteration of the Articles

The following are examples of matters, to authorize which directors' minutes are necessary—

The issue of share capital

Allotment of shares
Calls
The forfeiture of shares
Adoption of contracts
Appointment and remuneration of officials
Declaration of interim dividends and, if authorized by the Articles, final preference dividends
Appointment and remuneration of managing director

In an Australian case under the name *Wallerawang Collieries Ltd* v *Brierly and Others*, which appears and is reviewed in *The Accountant* of the 23rd June, 1934, the case turned upon the Minute Book. The secretary had defrauded the company to the extent of over £17,000 in connexion with eighty-five cheques. The directors' minutes contained lists of the cheques drawn and had the lists contained in the Minute Book been compared by the auditors with the Pass Book the fraud must have been discovered. Damages were claimed against the auditors, but the Court found in their favour.

In cases when information is disclosed in the Minute Books, in the writer's opinion, an auditor is unwise if he does not apply reasonable tests with a view to verification of such transactions with the records in the books of account.

Dividends

The declaration of dividends is vested in the shareholders, except in the case of interim dividends, and in some cases the interim and final dividends upon preference shares, in which cases the Articles sometimes expressly authorize the directors to declare these. Articles usually provide that the directors shall recommend the dividends to be declared by the shareholders, and that the shareholders shall have no power to vote dividends in excess of those recommended by the directors. According to the general practice, no entries are made in the books or the accounts until after a dividend has been declared, and dividends proposed by the directors are not included in the accounts presented to the shareholders, but in the Directors' Report. Immediately the dividends are declared by the shareholders the entries must be passed through the books, for the dividend then becomes a legal

liability In practice, proposed dividends are, however, commonly included in the accounts of a company, provided that the position is made quite clear on the accounts, there is no call for any action on the part of the auditor The practice of including proposed dividends in the accounts is gaining ground and is strongly recommended by the author, whose views upon this point are explained in Chapters IV and XIII

INTERIM DIVIDENDS There must be express power in the Articles to declare interim dividends, and an auditor must, therefore, inspect the Articles and the directors' minute declaring the dividend Before declaring, however, the directors must use reasonable care in order to satisfy themselves that such dividend is justified, and, for this purpose, accounts for the half-year or period should be prepared, full provision being made for depreciation, reserves for bad debts, and outstandings The condition of trade, and the prospects of the coming half-year or period should be considered, for it is quite possible that the first half of the year may show a profit, which may be entirely swallowed up by a loss in the succeeding half-year, and it must be remembered that an interim dividend is on account of the full year's profits If a Budget system is in force, the Budgets will be a great assistance in this connexion It should also be seen that the company has sufficient cash available to pay the dividend If asked to advise as regards the declaration of an interim dividend, an auditor should go into all the circumstances most carefully, and see that proper accounts have been prepared, and that the whole position has been adequately considered

DIVIDENDS ON PREFERENCE SHARES The Articles sometimes give the directors power to declare the dividends upon the preference shares, in which case, again, they must use every precaution to see that the accounts justify such dividends If there is no such express power in the Articles, preference dividends, like dividends upon the ordinary shares, can only be declared by the shareholders

VOUCHING DIVIDENDS The auditor must inspect the minute declaring the dividend and see that the total paid agrees therewith Income tax must be deducted

unless the dividend is declared "free of tax," and, in the former case, the gross amount of the dividend is generally debited to Appropriation Account, and the tax deducted credited to the Income Tax Account, against the tax payable under the assessment made upon the company This is the common practice in this country, but several companies are now debiting dividends less income tax to the Appropriation Account, and this course is, in the author's opinion, preferable In the case of income tax deducted from a dividend, the company is not accountable for this to the revenue The company's income tax liability is arrived at upon the basis of its Profit and Loss Account, and is in no way affected by dividend payments In the writer's opinion, therefore, it is desirable to show in the accounts the full charge for income tax and to show in the Appropriation Account the actual payment to the shareholders for dividend and which is the net amount

With income tax at 4s in the £ a dividend at the rate of 5 per cent less tax and one at 4 per cent free of tax result in exactly the same payment to the shareholders, i e £4 upon every £100 of share capital In both cases the final effect, as regards the company and the shareholders, is exactly the same, the only difference being that the wording of the dividend resolution is not the same In these circumstances, in the writer's opinion, the orthodox practice is most confusing as it results in the Appropriation Account being shown quite differently in these two cases

In the case of interest on debentures and loans, the company is accountable to the Revenue for the income tax deducted upon payment of such interest In this case therefore Interest Account must be debited with the gross interest and the income tax deducted should be credited to the Income Tax Account The income tax liability debited to this account will include the liability in respect of the income tax upon such interest The amounts paid to the various shareholders can be vouched with the returned and receipted dividend warrants

An increasing number of public companies in this country are adopting this practice, which was endorsed in leading articles that appeared in *The Accountant*, Vol XCI, page 265, and Vol XCVI, page 254

UNPAID DIVIDENDS If certain shareholders cannot be traced, the dividends declared and due to them should be credited to a special account, and shown separately on the Balance Sheet The Articles sometimes fix a period after the expiration of which, if such dividends have not been claimed, they may be forfeited—but there must be express power to this effect, otherwise dividends do not become statute barred until the expiration of twenty years from the date of declaration, and the shareholder can claim them at any time within this period Forfeited dividends should be transferred to general reserve, although, subject to the Articles, there is nothing to prevent a company crediting them to Profit and Loss Account

ARREARS OF CUMULATIVE PREFERENCE DIVIDENDS If there are arrears of dividend upon cumulative preference shares, the amount of such arrears should be stated upon the Balance Sheet in the form of a note, but an auditor cannot insist upon this No actual liability exists at date, and no liability will arise unless and until sufficient profits are made in the future, and, further, until the arrears of dividend are declared either by the directors or by the shareholders, according to the terms of the Articles It will be seen, therefore, that this is a question of the future If and when sufficient profits are made, these arrears will have to be made up before there can be any dividend to the ordinary shareholders, and it will then be the duty of the auditor to see that this is done But, in the meantime, it cannot be said that the Balance Sheet does not show a true and correct view of the state of affairs unless a note of the arrears of preference dividend is stated, for the Balance Sheet reveals the position of the company as a whole at a given date, whereas, the only purpose served by such a note is to show how the first profits which may become available for distribution in the future will be divided between the different classes of shareholders

CHAPTER X

PROFITS AVAILABLE FOR DIVIDEND

IN the case of a company, the accounts are prepared by the directors, in whom also rests the power to recommend the dividends to be declared by the shareholders in general meeting The shareholders appoint their auditor for the express purpose of ascertaining whether the accounts laid before them show the true and correct position of affairs, and, consequently, whether or not any profits, shown as available for distribution, have, in fact, been earned The shareholders must of necessity depend upon the auditor in this respect, and, therefore, it will be seen that the question of what profits are available for dividend is one with which an auditor constantly has to deal It follows that it is essential that he should have a thorough knowledge of this most complicated question

Profits Available for Dividend

In Chapter IV it is shown that in most cases it is impossible to obtain absolute exactitude in ascertaining the profits of a business, because such profits are dependent upon the valuation of the assets of the concern A true profit should be represented by a corresponding increase in the surplus of assets over liabilities, but as it is impossible in most cases to arrive at the exact value of all the assets, it is necessary that the value thereof should be estimated in accordance with certain accepted rules Further, true profit is not arrived at unless the original capital, plus any additions thereto, is intact, therefore, if any part of such capital has been invested in assets that have depreciated in value by reason of the fact that they are of a wasting nature, or are in process of being consumed in the course of earning revenue, or if, for any other reason, any part of the capital has been lost, then such wastage must be made good out of revenue before the true profits can be ascertained However, the Companies Act, 1929, neither provides as to the exact manner in which the profits

of a company are to be ascertained, nor does it enact that only "true profits" may be distributed as dividend

The periodical ascertainment of the profits of a business is an operation of such practical importance as to be essential to the safe conduct of the business itself, but to follow out the strict consequences of the above conception of profit in making out the annual accounts would often be very difficult in practice Hence the strict meaning of the word "profit" is rarely observed in drawing up the accounts of firms and companies These are domestic documents designed for the practical guidance of those interested, and so long as the principle on which they are drawn up is clear, their value is diminished little, if at all, by certain departures from the strict definition, which lessen greatly the difficulty of making them out Hence certain assumptions have become so customary in drawing up Balance Sheets and Profit and Loss Accounts that it may almost be said to require special circumstances to induce parties to depart from them (*Spanish Prospecting Co Ltd*)

It will be found that in some cases profits may be available for dividend, although the original capital of the company is not intact In every individual case in practice, the provisions of the Memorandum and Articles of Association of a company are of the utmost importance when considering the question of the divisible profits For if, when a company is formed, it is provided in its Articles that losses of capital shall be made good out of profits, and the method of ascertaining the profits available for distribution is precisely defined, these provisions will be compulsory in this particular case If, on the other hand, the Articles provide that the original capital need not be kept intact out of current revenue, then in such a case it may quite well be that a company could pay dividends out of bona fide trading profits, without replacing previous losses of capital For, in such cases, it is with a knowledge, actual or presumed, of the terms of the Articles that shareholders have subscribed and that creditors have traded with the company and although the payment of dividends might be deemed financially imprudent, the Companies Act does not prohibit such a proceeding, and neither shareholders nor creditors can subsequently complain of what was one of the express intentions of the company

From time to time circumstances of difficulty have arisen in practice in connexion with the question of the profits available for dividend in particular cases, and have

become matters of dispute between interested parties As the Companies Act is not definite upon this subject, the points in dispute have had to be submitted to the Courts for decision In such cases, the whole of the circumstances are investigated, and the Court decides what is fair and equitable in the circumstances of the particular case There are several very important cases that have been decided in this way, and the rules thus laid down are applicable in cases in which the circumstances are identical But it must be borne in mind that the Courts decide any particular case entirely upon the circumstances of that case, and, further, that previous decisions may be reversed when a similar case comes before the Courts again Therefore, the decided cases can be accepted only as an indication of what the Courts probably would decide in similar circumstances Again, as the rulings in decided cases are not all entirely in accord with one another, it is extremely difficult to generalize upon this subject However, two root principles are that the shareholders' capital may not be used to pay a dividend, and that a dividend can only be paid out of a bona fide surplus or profit For example, if a company were to distribute the proceeds of sale of one of its fixed assets, such a dividend would be paid out of capital, and would be in reality a return to the shareholders of part of the capital that they subscribed If a company paid a dividend in spite of the fact that the Profit and Loss Account showed a loss, then, again, such dividend would have been paid out of capital, for there would be no surplus or profit available out of which it could be paid If, in the accounts, the profits are overstated and the whole of such supposed profits have been distributed as dividend, the dividend must have been paid out of the shareholders' capital, to the extent to which the profits are overstated

When arriving at the profits available for dividend, against the income of any period, there must, of course, be charged all the current expenditure and charges that have been incurred in producing such income, but points of considerable difficulty arise in connexion with the treatment of the depreciation of wasting assets and capital losses, and these will now be considered

Capital Profits

The surplus, or profit available for distribution as dividend, is not confined to revenue profits only, but in certain cases may include capital profits Suppose, for example, a fixed asset costing £1500 is sold for £2000, a clear surplus or profit of £500 has been made, and assuming that, apart from this, the share capital remains intact, this £500 could be distributed as dividend without violating the above principles

In the case of *Lubbock* v *British Bank of South America* the company had sold its business in Brazil and had realized upon this sale a profit of £200,000 It was held that this profit was available for distribution as dividend

In the case of *Foster* v *New Trinidad Lake Asphalte Co Ltd*, the company upon its formation had taken over, amongst other assets, a debt of \$100,000, this debt being deemed to be of no value Subsequently, this debt realized £26,258, and it was sought to treat this sum as a capital profit and make it available for distribution as dividend It was held that this sum could not be distributed as dividend without having regard to the results shown by the accounts as a whole Part of the judgment reads—

> I must not, however, be understood as determining that this sum or a portion of it may not properly be brought into Profit and Loss Account in ascertaining the amount available for dividend That appears to me to depend upon the result of the whole account for the year It is clear, I think, that an appreciation in total value of capital assets, if duly realized by sale or getting in of some portion of such assets, may, in a proper case, be treated as available for purposes of dividend

From this it is clear that a profit on the realization of one capital asset cannot be distributed as dividend without having regard to the results shown by the year's accounts as a whole

Wasting Assets

In the case of *Lee* v *Neuchatel Asphalte Co*, it was decided that where a company was formed to work a wasting asset, such as a mine, and its Articles specially stated that it was not necessary to provide for the depreciation of such wasting asset, there was nothing in the Companies Acts to compel it to do so

In the case of mines, depreciation of the mine itself is

not, in practice, usually provided for out of the current profits, because ordinarily the object of a mining company is to work a particular mine only, and not to acquire and work other mines after the original one is exhausted. The life of the company is, therefore, roughly equal to the life of its principal asset, and when the latter is worked out the company will wind up.

The position, therefore, is a somewhat peculiar one, for it will be seen that the ore that is sold is part of the company's main capital asset, and that when the whole of the ore has been raised and sold the value of the mine is entirely exhausted, apart from any scrap value there may be in surface works and land. Ordinarily, the main object of such a company is to acquire this asset, sell the whole of the valuable part thereof—that is, the ore—and then to wind up. Now, what is the actual effect of providing for depreciation in such a case? Out of the proceeds of the sale of ore will be paid all the expenses of raising it, and all the expenses, losses and charges of the company, and now, further, it is proposed to charge against each year's Profit and Loss Account a sum sufficient to accumulate, by the time the mine is worked out, the whole of the original capital sunk in acquiring and equipping the property; therefore, if these provisions for depreciation are correctly estimated, then, when the company is finally wound up, the shareholders' capital will be returned to them in full.

During the life of the mine the whole of this capital which is gradually being accumulated is not required for the purposes of the business. If the company started with sufficient working capital, therefore, the whole of these accumulated funds must be invested outside the business, and so remain until the final winding up, when they will be realized and paid over to the shareholders. It will be seen that there is no asset requiring replacement, and that this question affects the position only upon final winding up. The whole of the amounts realized upon the sale of ore, after payment of all expenses, are payable to the shareholders, but if depreciation is provided for, a proportion thereof will not be paid over as and when they are realized, but will be accumulated and paid over only at the end of the life of the mine.

Now, in practice, shareholders, as a rule, prefer that the whole of the surpluses, after expenses have, of course, been deducted, should be paid over to them at once, and not that large sums should be accumulated in the hands of the directors The original capital invested in the mine is regarded "as sunk and gone, and if the company retains assets sufficient to pay its debts, any excess of money obtained by working the property, over the cost of working it, may be divided amongst the shareholders" With each dividend the shareholders are in this way in effect obtaining a partial return of capital, and, therefore, individually, they should not regard the whole dividend as income, but should treat part as a return of capital, and re-invest that part Upon winding up, of course, probably there will be little or no return to the shareholders, but they will look to the dividends paid during the life of the mine to repay to them their capital, and also to pay them for the use of it

It is suggested by some, therefore, that this is quite a reasonable business proposition, and there is nothing in the Companies Act to prevent a company adopting this policy, so that, if the shareholders decide on this course, and, for instance, provide to this effect in the Articles of the company, the law will not prevent them from doing so If, on the other hand, they decide that the depreciation of the wasting asset shall be charged against profits, and provide to this effect in the Articles, then the company is bound to provide for such depreciation out of the current earnings before showing profits available for dividend, it will be seen that the whole matter, in these circumstances, rests in the hands of the shareholders, and it is the auditor's duty to see that the whole situation is made quite clear to them

The principle of not providing for depreciation of such wasting assets is undoubtedly an unsound financial policy Against the proceeds of the sale of the ore there should obviously be charged, in addition to the cost of raising, the cost *in situ* of such ore It is strongly contended by many authorities that full provision should be made for the depreciation arising directly in consequence of the extraction of the minerals As the law stands, however,

it is not compulsory to provide for such depreciation and therefore the auditor cannot in practice enforce his views, however strongly he may be of opinion that the principle is unsound.

In the past, in cases where depreciation of the wasting asset was being provided for, the funds so accumulated could not be utilized during the lifetime of the company in order to redeem share capital, but the Companies Act, 1929, gives companies the power to issue redeemable preference shares. The wise course in the future, it is suggested, would be to issue such redeemable preference shares to an amount covering the value of the wasting asset and redeem the capital out of revenue over the period of the wasting asset's life. In this way the annual amounts distributed would be clearly earmarked as to the proportions representing capital and income respectively, and thus the position would be made clear to the individual shareholders.

Depreciation of Plant and Machinery

Before going further, it may be well to contrast the above position with that of a manufacturing company as regards the capital sunk in plant and machinery. In this latter case, it will be seen that the object of the company is *not* to continue only for the term of the life of the original plant, but to continue to trade more or less indefinitely. Therefore, in order to carry out this object, when the original machinery is worn out and useless, the same must be replaced, or the company cannot continue to trade. Therefore, out of the earnings of the original machinery, there must be provided a sum for the depreciation thereof, so that, during the period of its working life, the capital sunk is replaced, and, when the machinery is worn out, this sum is available to purchase the necessary new plant. Therefore, when *assets must be replaced* in order that a company may carry out its objects, the depreciation of such assets must be provided for.

This is made clear in the case of *Re Crabtree, Thomas* v. *Crabtree,* part of the judgment reading—

But in the ordinary course of ascertaining the profits of a business where there is power machinery and trade machinery which is necessary in order to perform the work of the business, it is, in my opinion, essential

that in addition to all sums actually expended in repairing the machinery, or in renewing parts, that there should also be written off a proper sum for depreciation, and that sum ought to be written off before you can arrive at the net profits of the business The only authorities referred to were those of companies formed to work a wasting property, and in such a case all profit arising from the wasting property is divisible without any deduction for the depreciation in value of the wasting property That is because the object of the company was to acquire a wasting property and to divide all the profits That is not so here The profits of this business are not ascertained until a sufficient sum has been deducted to meet the depreciation of the machinery

Capital Losses

Another very important case is *Verner* v *General and Commercial Investment Trust* In this case, the company owned various investments producing income, and the Profit and Loss Account showed a profit, but the value of the investments had seriously depreciated

The question raised by this case was whether a company which had lost part of its capital could lawfully declare or pay a dividend without first making good the capital which had been lost, it was held that, although this course might sometimes be very imprudent, yet there was no law which prevented it in all cases and under all circumstances Part of the judgment reads as follows—

> There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact either before or after the winding up of the company A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value But, in the absence of some special Article or contract, there is no law to this effect, and, in my opinion, for very good reasons It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company either not in debt or well able to pay its debts, from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk Even a sinking fund to replace lost capital by degrees is not required by law

It will be seen that the company, by declaring this dividend, is not paying the same *out of* the shareholders' capital, but is paying it *out of a bona fide revenue surplus,* but without providing for a *previous loss of capital,* which is quite a different matter, the point, therefore, is Must losses of fixed capital be made good out of revenue, before profits are available for dividend? From this and other

cases, it would appear that the matter, again, rests with the shareholders If the company provides that its capital must be kept intact before profits are available, then the company is bound to do so, but if the shareholders do not require their capital to be maintained out of revenue, then this course is not illegal, and, provided there are bona fide revenue surpluses, these are available for dividend

But it must be observed that this case clearly holds that floating assets must be properly depreciated before arriving at the amount of the profits available for dividend, for part of the judgment reads as follows—

> Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law

In the circumstances of this case the non-provision for capital losses was unquestionably a bad financial policy, but this case would appear to show that there is nothing in the law to compel a company to run its business upon sound financial lines, so that if, for instance, a company provides in its Articles that it need not keep up capital out of revenue, then every shareholder subscribes upon this basis, and, consequently, there is nothing illegal in the company carrying out this policy

In the case of *Bolton* v *Natal Land and Colonisation Co*, the position was that in the year 1882 a bad debt of £70,000 was incurred and was written off to Revenue Account At the same time the value of the company's land was written up by £70,000, this increase being credited to Revenue Account In the year 1885 a trading profit was made and a dividend declared This action was brought to restrain the payment of the dividend, on the grounds that the value of the land was overstated and that the difference between the true value of the land and the book value should be written off against the available profits It was held that even assuming that part of the capital had been lost in the past and had not been subsequently made good, that that was not sufficient ground for restraining the payment of the dividend

In the case of *Wilmer* v *McNamara* it was held that the company could declare a dividend without providing for depreciation of fixed assets A trading profit of £5800 had been earned, but no provision was made for depreciation of leases, goodwill or plant, although, in previous years, depreciation to a considerable extent had been provided for The judge, however, appeared to be doubtful as to whether sufficient depreciation had been provided for the leaseholds

In the case of *The Ammonia Soda Company, Limited,* v *Chamberlain and Others,* the circumstances were that the company had a debit balance upon Profit and Loss Account of £12,970 In boring for water a new bed of rock salt of a thickness of 666 feet was discovered, the existence of which was previously entirely unknown and unsuspected The value of the company's land was written up by £20,542 and the debit balance on the Profit and Loss Account was set off against this increase This transaction was made clear in the published accounts Subsequently profits were earned and paid away as dividend The company brought this action against the directors, contending that the dividend had been paid out of capital and seeking to make the directors liable to refund It was held that these dividends could not be restrained, part of the judgment reading as follows—

> In his (his Lordship's) opinion the directors in acting as they did were merely stating in their Balance Sheet what, upon reasonable grounds, they believed to be the real value of their assets The dividends complained of, paid out of net earnings in the subsequent years, were not paid out of capital but out of profits, and the defendants were, in his opinion, under no liability whatever to repay them or any part The real question was—were these dividends paid out of capital? There was no dispute between the parties that these dividends were not paid out of the subscribed capital in the ordinary sense, on the contrary, it was admitted that they were paid out of net profits earned during the period in respect of which the dividends were paid The plaintiffs contended, however that although these were net profits earned during the period, they were not available for dividend and could not really be considered profits as in the earlier period of the company's history a loss had been incurred, and that until such loss had first been made good, there could not be any profits in the true sense of the word In his Lordship's judgment this argument was unsound and had been exposed again and again The Companies Acts did not impose any obligation upon a limited company, nor did the law require that it should not distribute as dividend the clear net profits of its trading unless its paid up capital was intact or until it had first made good all losses incurred in previous years

From a consideration of these cases it is clear that a company is not bound to make good, out of subsequent trading profits, previous losses of capital

In the case of *Stapley & Read Bros Ltd*, the circumstances were that the company had written off out of profits the whole of the goodwill, £140,000 In addition, undistributed profits to the amount of £40,000 had been capitalized by the issue of 40,000 £1 bonus shares Subsequently, losses were incurred and at the end of the year 1923 the Profit and Loss Account showed a debit balance of £20,504 and the preference dividends had not been paid for the three years 1921, 1922, and 1923

The directors proposed that £40,000 should be credited to reserve and debited to goodwill, thus writing back to reserve part of the profits that in previous years had been capitalized The directors also proposed that the debit balance of £20,504 on the Profit and Loss Account should be written off against this reserve, and that the three years' preference dividends should be declared and paid out of the balance on the Reserve Account

The action was brought with a view to restraining the payment of these dividends upon the grounds that profits originally applied in writing down the value of assets should not subsequently be written back

The action failed upon the grounds that if the amounts written off goodwill out of profits had been credited to reserve instead, they would have been available It was admitted that the goodwill was worth £40,000 The past accounts had been approved by the shareholders, but they had not thereby bound themselves permanently to capitalize the profits used to write down goodwill The Judge held, therefore, that the shareholders could write back the £40,000 and that this transaction was not contrary to the Acts or the company's regulations, and it was not prejudicial to the creditors

The case of *Brown* v *Gaumont British Picture Corporation Ltd* raised the question as to whether the premium on an issue of shares was available for distribution as dividend The dividend was upheld, part of the judgment reading "subject always to the question whether there may be something in the Articles of Association that inter-

feres with it, there is nothing legally wrong in a company dividing among its shareholders a premium obtained on the issue of shares so long as the sum it pays out does not form part of the capital subscribed upon the shares, but the premium, of course, is something additional to the capital subscribed upon the shares" Upon this subject the reader is referred to a very able article appearing in *The Accountant*, Vol XCVI, page 894

The Interests of Creditors

One of the main objects of the rule prohibiting the payment of dividends out of capital, is that the funds available to pay creditors must not be depleted by the payment to shareholders of improper dividends Part of the judgment in the case *Guinness* v *Land Corporation of Ireland* reads as follows—

> the capital of the company as mentioned in the Memorandum is to be the fund which is to pay the creditors in the event of the company being wound up From that it follows that whatever has been paid by a member cannot be returned to him In my opinion, it also follows that what is described in the Memorandum as capital, cannot be diverted from the objects of the society It is, of course, liable to be spent or lost in carrying on the business of the company, but no part of it can be returned to a member so as to take away from the fund to which the creditors have a right to look, as that out of which they are to be paid

It will be seen, therefore, that, in the interests of the creditors, the capital of a company must be used exclusively for the purposes of carrying out the objects of the company Such objects are set out in the Memorandum Further, a dividend may be paid only out of a bona fide surplus or profit, as otherwise the capital available for the payment of creditors is reduced

Position of the Auditor as Regards this Question

The auditor has no concern in the prudence or imprudence of the financial policy of a company, except in so far as he may be requested to give his advice The auditor's responsibilities are to see that the regulations of the company are complied with and that the position of affairs is made clear in the accounts submitted to the shareholders For this purpose, therefore, he must be fully conversant with the principles and rulings governing this question, and in

cases that arise in practice he must investigate thoroughly the whole of the circumstances If the auditor is of opinion that the accounts do not show a true and correct view of the state of the company's affairs, then if the directors refuse to amend the accounts, he must report to the shareholders, when his responsibilities are complied with

Conclusions

The conclusions to be drawn from a consideration of these cases may be summarized as follows—

(1) The law does not attempt to define how profits available for distribution as dividend are to be arrived at This question is left to each company to decide for itself, provided that the company's regulations are complied with

(2) Share capital cannot be distributed as dividend

(3) A dividend pre-supposes a surplus or profit

(4) A dividend cannot be paid which has the effect of leaving the company in the position of not being able to pay its creditors

(5) A company formed to work a wasting asset need not provide out of profits for the depreciation of such asset provided that this is in accordance with the company's regulations

(6) Losses of capital need not be made good out of subsequent profits, provided that the regulations of the company do not provide to the contrary

(7) Capital profits are available for distribution as dividend, provided that they are realized profits, and that in arriving at the amount available, all charges and losses, both capital and revenue, for the period are brought into account

(8) In the case of a manufacturing company, provision must be made for depreciation of plant and machinery

(9) The whole position of affairs must be made clear to the shareholders in the accounts submitted to them and it is the duty of the auditor to see that this is the case

(10) It is for the shareholders to decide what shall be distributed as dividend, and such dividends cannot be restrained provided that they are in accordance with the company's regulations, they comply with the foregoing rulings, and that they are based upon honest accounts

CHAPTER XI

THE LEGAL POSITION OF AUDITORS

THE subject of the exact legal position of auditors is one of considerable complexity and difficulty The various Acts of Parliament dealing with the appointment of auditors do not define exactly the auditor's responsibilities and liabilities There are several important cases dealing with the subject which indicate the legal view, but it is thought that finality has not yet been reached Even in the accountancy profession opinions differ, it is essential, therefore, that every auditor should give this matter most careful consideration, as each practitioner must, to a large extent, fix his own standard, but by acting up to a high sense of responsibility, the greatest service is rendered to the profession as a whole, and in the end to each individual member thereof It is impossible, in the space available, to deal exhaustively with this subject, but some of the most important cases will be considered, and, thereafter, the conclusions to be drawn therefrom will be summarized

The Position of an Auditor to a Private Firm

In the case of private firms, an auditor is not appointed under any statute, but is responsible in damages if his employers suffer any loss through his neglect or default

In all cases where an accountant is employed to do either audit or accountancy work for a private firm, it is of the utmost importance that a clear understanding should be come to with his client as to the exact scope of the work he is to do This point has been dealt with in Chapter I in discussing the difference between the duties of auditors appointed under statute and by private individuals or firms, and reference was made to the cases of *Apfel* v *Annan Dexter & Co*, *Maritime Insurance Co Ltd* v *William Fortune & Son*, and *Leech* v *Stokes and Others*

Auditor's Position under the Companies Act, 1929

Under the Companies Act, 1929, Section 362, if an auditor in any report, certificate, Balance Sheet, or other

document, makes a statement false in any material particular, knowing it to be false, he is guilty of a misdemeanour, and is criminally liable, and, further, should he be convicted under this section, this will not relieve him from his liability in addition to pay damages in respect of his default.

Under Section 276, Companies Act, 1929, it is generally accepted that the Court has power to assess damages against an auditor, as an officer of the company, if he has been guilty of any breach of trust in relation to the company. This section applies only where the company is in the course of being wound up.

Except for the above two sections, the Companies Acts are silent as to the exact responsibilities of auditors in connexion with the audit of the accounts of companies. But it would appear that, as the agent of the shareholders, an auditor must exercise reasonable care and skill in the carrying out of his duties, and that, if he fails and his clients suffer damage through his neglect or default, he is liable to them in damages. What is reasonable care and skill depends upon the whole of the circumstances of the particular case. But it must be pointed out that it is here that the whole difficulty of this question arises, for the circumstances of individual audits vary enormously, and there are no definite rules laid down as to the steps that an auditor should take before he is satisfied as to the correctness of a Balance Sheet. Further, there is no doubt that there is no uniform accepted practice in the accountancy profession, nor is it easy to see how there could be, except as regards general principles. The auditor must decide for himself in each case, as to what steps are necessary, and, for this purpose, an auditor must be possessed of considerable skill, knowledge and judgment. In this book an endeavour has been made to set down the general principles that should underlie every audit, in order that the auditor may comply with his moral and legal responsibilities, but it cannot be claimed that they represent the accepted practice of the profession.

An auditor is entitled to access to all the books, accounts and vouchers of the concern whose accounts he has to audit, and, in addition, he is entitled to such additional information and explanations as he may require. In the

case of registered companies, these rights are given to him specifically by Section 134, Companies Act, 1929, and his powers and the scope of his audit cannot be limited in any way by either directors or shareholders, but in the case of private firms the scope of an audit can be limited by agreement, in which case the auditor's responsibilities are limited accordingly, but in such circumstances, as is pointed out in Chapter I, it is of the utmost importance that the exact terms of the arrangement should be recorded in writing, otherwise serious difficulties may arise in the future

Auditor's Liability for Neglect

The liability of an auditor arises where it is proved that, through his neglect or default, his clients have suffered damage This may arise, for example, where actual defalcations have taken place on the part of officers or employees of the concern, such as misappropriation of cash or stock In the case of companies, the auditor's liability also may arise where the results shown by the accounts have been overstated, either through an error or by reason of deliberate falsification, resulting in the payment of dividends out of capital This may be effected by over-estimating the value of assets, such as debtors and stock, by insufficient provisions for depreciation of other assets, or by the omission to provide for liabilities In such cases, the auditor may be held personally liable, if it is proved that, had he exercised reasonable care and skill, he must have discovered the discrepancy

Auditor's Liability as Regards Third Parties

It must also be remembered that third parties may also be misled and thus suffer damage by reason of accounts certified by an auditor, for example, prospective creditors, debenture-holders, investors, purchasers of the business, or intending partners may have produced to them the audited accounts of the business with which they are proposing to enter into business relations However, from the case of *Le Lievre and Dennes* v *Gould*, it would appear that, in the absence of fraud, an auditor would not be held liable to third parties who had suffered damage,

even though he had been negligent He is not employed by them and appears to owe them no duty But a conscientious auditor should recognize a moral obligation towards third parties who otherwise may suffer through his neglect

Legal Decisions

There are several very important decisions upon this subject, all of which should be studied, but there is only space here to consider the leading cases

Leeds Estate Building, etc , Society *v* Shepherd In this case it was held that it is not sufficient for an auditor merely to compare the Balance Sheet with the books of account, and thus verify its arithmetical accuracy, but that he must satisfy himself that the Balance Sheet is a "true and accurate representation of the company's affairs " In this case the terms of the Articles had not been carried out, and it was held that "it was no excuse that the auditor had not seen the Articles when he knew of their existence " As a result of the auditor's neglect, dividends, directors' fees and bonuses were improperly paid, and he was, therefore, held liable for damages

London and General Bank Case In this case it was held that where an auditor does not report to the shareholders that the Balance Sheet is incorrectly drawn, knowing it to be the case, he is guilty of a misfeasance In this case the company had advanced considerable sums to customers, but the securities held by the bank were wholly insufficient The company had, however, taken credit for the interest accrued due upon such loans, whereas the interest was never, in fact, paid One of the chief causes of the bank's failure was the heavy loss in respect of these loans, and, had proper reserves been made for bad debts, no profits would have been shown available for dividend The auditor apparently was aware of the real state of affairs, and reported fully to the directors, who, however, refused to alter the accounts In his report to the shareholders, the auditor made no mention of the lack of security, etc , but merely stated "The value of the assets as shown by the Balance Sheet is dependent upon realization " The auditor was found guilty of a

misfeasance, and was held jointly and severally liable with the directors in respect of two dividends declared, amounting to some £14,400 odd, on the ground that he ought to have reported the true facts to the shareholders, the words contained in his report to them being quite meaningless, and, therefore, he had failed in his duty, as a result of which failure the company had paid these dividends out of capital Part of the judgment reads as follows—

It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do An auditor has nothing to do with the prudence or imprudence of making loans with or without security It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably, it is nothing to him whether dividends are properly or improperly declared provided he discharges his own duty to the shareholders His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that But then comes the question How is he to ascertain such position? The answer is By examining the books of the company But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position He must take reasonable care to ascertain that they do Unless he does this, his duty will be worse than a farce An auditor, however is not bound to do more than exercise reasonable care and skill in making inquiries and investigations He is not an insurer, he does not guarantee that the books do correctly show the true position of the company's affairs, he does not guarantee that his Balance Sheet is accurate according to the books of the company If he did, he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say, by the fraudulent concealment of a book from him His obligation is not so onerous as this

Such I take to be the duty of the auditor, he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true

What is reasonable care in any particular case must depend upon the circumstances of that case Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient, and, in practice I believe business men select a few cases haphazard, see that they are right, and assume that others like them are correct also Where suspicion is aroused, more care is obviously necessary, but still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required

The Balance Sheet and certificate of February, 1892, that is, for the year 1891, was accompanied by a report to the directors of the bank Taking the Balance Sheet, the certificate, and report together, Mr Theobald stated to the directors the true financial position of the bank, and if this report had been laid before the shareholders, Mr Theobald would have completely discharged his duty to them Unfortunately, however,

this report was not laid before the shareholders, and it becomes necessary to consider the legal consequences to Mr Theobald of this circumstance

A person whose duty it is to convey information to others, does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more Information and means of information are by no means equivalent terms An auditor who gives shareholders means of information instead of information in respect of a company's financial position, does so at his peril and runs the very serious risk of being held, judicially to have failed to discharge his duty

In this case I have no hesitation in saying that Mr Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the Balance Sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words "the value of the assets as shown on the Balance Sheet is dependent upon realization " It is a mere truism to say that the value of loans and securities depends upon their realization We are told that a statement to that effect is so unusual that the mere presence of those words is enough to excite suspicion But, as already stated, the duty of an auditor is to convey information, not to arouse inquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement, if, as in this case, its language expresses no more than any ordinary person would infer without it

Irish Woollen Co *v* Tyson In this case the auditor was held liable for damages where the accounts had been falsified by the suppression of invoices, it being held that had he used reasonable care and skill, he should have discovered the fraud Part of the judgment reads as follows—

For these reasons I am of opinion that if due care and skill had been exercised, the carrying over and the suppression of invoices would have been discovered, and the auditor is liable for any damage the company has sustained from the under-statement of liabilities in the Balance Sheet due to this cause since 4th January, 1892 I consider that not only are Mr Kevans and his assistants not free from blame for this, but also for the mechanical way the audit was carried out

Smith *v* Offer and Others This was an action brought by the liquidators of the company against the directors and auditors on the grounds that a dividend had been paid whereas in fact there had not been sufficient profit to cover it In his summing up, Mr Justice Bennett said—

that the liquidator had proved to his satisfaction that the company did not earn a profit of £3458 during the period in question No charge of dishonesty was made against any of the respondents and having seen all of them in the box and heard their evidence he was satisfied that with respect to all the charges made against them in these proceedings all the respondents acted honestly and in good faith

Referring to the auditor's clerk his Lordship stated—

It was upon the shoulders of this young man, without any supervision and with but very little assistance, that the whole burden of preparing the company s Balance Sheet and Profit and Loss Account and auditing the Balance Sheet fell

An overstatement of the profits was due to the fact that certain liabilities had been omitted and to the over-valuation of work in progress His Lordship stated that—

The liquidator had satisfied him that instead of there having been a profit of £3458 there had been a profit only of £297, and that the Balance Sheet did not therefore disclose a true and accurate statement of the company's position Was this erroneous certificate due to failure on the part of the auditor to perform his statutory duties? The answer in his Lordship's judgment was in the affirmative and [the auditor] was responsible for the failure of his servant

His Lordship stated that the auditor's

duty with regard to the ascertainment of unrecorded liabilities must depend upon the facts of each particular case and must be determined by the nature of the business carried on and the practice of the persons or bodies with whom the company did business of sending in their invoices If the auditors found that a company in the course of its business was incurring liabilities of a particular kind and that the creditors sent in their invoices after an interval, and that the liabilities of the kind in question must have been incurred during the accountancy period under audit, and that when he was making his audit a sufficient time had not elapsed for the invoices relating to such liabilities to have been received and recorded in the company's books, it became his duty to make specific inquiries as to the existence of such liabilities and also, before he signed a certificate as to the accuracy of the Balance Sheet, to go through the invoice files of the company in order to see that no invoices relating to the liabilities should have been omitted

The evidence had established to his satisfaction that no experienced auditor would have failed to ascertain the existence of the liabilities omitted from this Balance Sheet With regard to the over-valuation of work in progress, the expert evidence was that it was the duty of the auditor to check the figures at which work in progress was brought into the Balance Sheet It was the duty of [the auditor] to satisfy himself that nothing was included in the work valued as in progress on 31st March, which was, in fact, done after that date He had also to satisfy himself that all expenses or liabilities incurred by the company in connexion with the work so valued had been brought into account

His Lordship stated that the check made by the auditor's clerk was useless, and he was satisfied on the evidence that there was ample material with which the auditor's clerk could have tested the accuracy of the figures given him

The auditor was held guilty of negligence and liable in damages to the liquidators to the extent of the money the company had wrongly paid away, together with interest and costs

The directors were exonerated on the grounds that they had acted honestly and on the basis of a fully audited Balance Sheet

London Oil Storage Co *v* Seear Hasluck & Co In this case the auditors were held liable for damages, on the grounds that they had failed to verify the existence of the petty cash in hand, which according to the books amounted to £760, whereas, in fact, there was only £30, the difference representing the secretary's misappropriations

In this case it was clearly established that the directors had been negligent in their control of the affairs of the company No doubt for this reason the damages were limited to the nominal sum of £5 5s The fact remains however that the auditors were held to have been guilty of a breach of duty In this case the Lord Chief Justice stated

> I entirely agree with the view of the law as explained that the auditor cannot shelter himself for any breach of duty under the neglect of the directors he is there to do his duty to the company, the only point on which the conduct of the directors may become material is upon the subordinate question as to whether there is anything to arouse the suspicion of the auditor, and whether or not the loss has really been occasioned by the auditor's conduct The auditor most undoubtedly does undertake very considerable responsibilities and is liable for the proper discharge of his duties, and if by the neglect of his duty or by want of reasonable care, he neglects his duty, and damage is caused to the company as such, he is responsible for that damage The conduct of the directors is no answer to any breach of duty by the defendant, but it is a circumstance you must take into consideration, because if you are of opinion that the loss was occasioned by a man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the auditor is what we lawyers call a *causa causans* which contributed to, but would not be the cause of, the loss

The Kingston Cotton Mills Case In this case the accounts had been falsified to a very considerable extent by the managing director, by means of extensive over-valuations of the stock The stock had been certified by the managing director, and it was held on appeal that the auditor was entitled to accept such certificates, and that he was not liable in respect of the dividends that had been paid out of capital, as a result of the manipulation of the stock Parts of the judgment read as follows—

> For several years frauds were committed by the manager, who, in order to bolster up the company and make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and values of the

cotton and yarn in the company's mills He did this at the end of the years 1890, 1891, 1892 and 1893 There was no book of account (except the stock journal, to which I will refer presently) showing the quantity or value of the cotton or yarn in the mill at any one time The auditors took the entry of the stock-in-trade at the beginning of the year from the last preceding Balance Sheet, and they took the values of the stock-in-trade at the end of the year from the stock journal The book contained a series of accounts under various heads, purporting to show the quantities and values of the company's stock-in trade at the end of each year, and a summary of all the accounts showing the total value of such stock-in-trade The summary was signed by the manager, and the value as shown by it was adopted by the auditors and was inserted as an asset in the Balance Sheet, but "as per manager's certificate" The summary always corresponded with the accounts summarized, and the auditors ascertained that this was the case But they did not examine further into the accuracy of the accounts summarized The auditors did not profess to guarantee the correctness of this item They assumed no responsibility for it They took the item from the manager, and the entry in the Balance Sheet showed that they did so I confess I cannot see that their omission to check his returns was a breach of their duty to the company It is no part of an auditor s duty to take stock No one contends that it is He must rely on other people for details of the stock-in-trade in hand In the case of a cotton mill, he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the Balance Sheet In this case the auditors relied on the manager He was a man of high character and of unquestioned competence He was trusted by everyone who knew him The learned Judge has held that the directors are not to be blamed for trusting him The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade in hand, and they trusted him accordingly in that matter

It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use What is reasonable skill, care, and caution must depend on the particular circumstances of each case An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong He is a watchdog, but not a bloodhound He is justified in believing tried servants of the company in whom confidence is placed by the company He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful

His Lordship then referred to the circumstances which led to the auditors being deceived, and came to the conclusion that they were not wanting in skill, care, or caution in accepting the figures of the manager, and he concluded as follows—

The duties of auditors must not be rendered too onerous Their work is responsible and laborious, and the remuneration moderate I should

be sorry to see the liability of auditors extended any further than in *re The London and General Bank*. Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable.

From this case, therefore, it would appear that an auditor is entitled to rely upon the certificate of a responsible official as regards the stock-in-trade, but, in the author's opinion, an auditor to-day would be running considerable risks if he acted too literally upon this decision, which is an old one, and opinions and practice have changed greatly since this case was decided. For, if the auditor were to accept, say, the manager's certificate, without in any way checking or testing the stock, the audit would be little short of a farce, for, although every other item in the Balance Sheet may be tested and checked in every way, yet if the auditor merely relies upon a certificate as regards the stock, it means that the official responsible for the valuation of the stock can make the accounts show whatever results he pleases, by manipulating the valuation of the stock, and the audit, therefore, in such circumstances, would be no guarantee at all that the accounts were correct, and would, therefore, in the case of a company, be no safeguard for the shareholders. In order, therefore, that the audit may be of some real value, the auditor must test the stock as far as is reasonably possible. In Chapter VI it is shown that there are many ways in which the stock may be tested; in fact, in some cases, it is possible to check the stock fairly completely, but in others, especially where there are goods in course of manufacture, it is almost impossible for an auditor to satisfy himself completely as regards this asset. However, he can, and there is no doubt he should, make inquiries and use reasonable tests, so that he can show, in the event of his being challenged, that he used every reasonable precaution in order to satisfy himself as to the correctness of this most important item in the accounts.

For the foregoing reasons, a too literal construction should not be placed upon the ruling in the *Kingston Cotton Mill* case, but, in duty to his clients and to himself, an auditor in every case should investigate the stock most carefully, and apply thereto every reasonable test. Such

investigations, it is suggested, are of far greater importance than the mechanical checking upon which some auditors expend such a large proportion of the time devoted to an audit

Arthur E Green & Co v The Central Advance and Discount Corporation Ltd In this case the auditors were charged with negligence, on the grounds that the profits of the company were considerably overstated, owing to the reserve for bad debts being insufficient, and also on the grounds that the item securities included leases that had lapsed The book debts included a great number of very old debts, many of which were statute-barred, but the auditors relied upon the manager's estimate of the reserve for bad debts Upon the death of the manager the new manager investigated the position and bad debts to the amount of £13,000 were written off The company claimed damages against the auditors upon the grounds that commissions had been paid to the managers to the extent of £950 on the overstated profits This case was decided in favour of the company and judgment was for £613 14s 11d The Judge stated that

> He desired to say, with regard to the cases that had been cited to him, that there did not seem to be any reported cases in which the exact duties of auditors, with regard to dealing with book debts, were laid down He thought it must rest upon the general principles of the law on professional negligence One had to fall back upon the words of the Statute If there were circumstances which seemed to call for inquiry, the auditor must make the proper inquiry, and if he did not take the proper steps to have the matter sifted, he did not fulfil the duty he owed to the company as one of its officers He [the judge] regretted very much that Mr Green's firm, possibly owing to the masterful nature of Mr Foot [the late manager], fell short of that standard, but he could not help arriving at that conclusion, and he therefore found as he had stated

From a consideration of this case, and the Scarborough Harbour Case which follows, it is clear how important it is that an auditor should carefully examine the ~~book~~ debts, with a view to ascertaining that the reserve for bad debts is sufficient to meet all bad and doubtful debts

Scarborough Harbour Commissioners v Robinson, Coulson, Kirkby & Co In this case damages were claimed against the auditors to make good losses sustained by the Commissioners by reason of the non-payment by J Sellers & Co Ltd, fish salesmen, who were tenants of the board, of arrears of rent and gas-money and also dues on the sale of fish

J Sellers & Co Ltd , was controlled by a Mr T Whitehead who was also chairman of the plaintiff board and of the finance committee Messrs Robinson, Coulson, Kirkby & Co , in addition to auditing the accounts of the Commissioners, were also auditors of J Sellers & Co Ltd

The case against the auditors was that Mr Robinson, the senior partner of the firm, put forward to the Commissioners Balance Sheets that included as good debts amounts owing by J Sellers & Co Ltd , whereas he, in fact, knew these debts to be bad or at least doubtful It was contended therefore that the auditors had been guilty of negligence and breach of duty to the Commissioners

In 1929 Mr Robinson became aware of the arrears of rent and gas dues and in July, 1932, through auditing the accounts of J Sellers & Co Ltd , he learned that the company owed to the Commissioners £180 for fish dues Mr Robinson then insisted upon a meeting of the finance committee being called It was then disclosed that there was owing by J Sellers & Co Ltd , a total sum of £351

Mr Justice Crossman in his judgment—

> held that in 1929 the defendant firm ought to have reported the matter of the arrears of rent and gas money formally to the board or to the finance committee, and if they were not satisfied they ought to have made a note on the Balance Sheet He held that in not doing so they were guilty of negligence and ordered an inquiry as to damages

On appeal, this decision was reversed

Briefly the grounds upon which the Court of Appeal reversed the judgment appear to be that whereas Mr Robinson knew that Sellers & Co Ltd were in a bad way, yet in his honest opinion the position was not hopeless and he knew that Mr Whitehead had resources upon which in the past he had drawn from time to time to meet the liabilities of his company Mr Robinson was also aware of the fact that it was the policy of the board not to press for these debts Mr Robinson made inquiries as regards these debts and came to the honest conclusion that they were good

In the course of the judgment the Master of the Rolls said—

> It is difficult to reconstruct the position as it stood before Mr Robinson What was his duty? Was it to tell the Commissioners what debts they ought to sue for, what debts they ought to forgo? Is it for him to say

when indulgence ought to be given and when stringency ought to be applied? I do not think that is a right test to apply to an auditor We must take the circumstances broadly without any particular definition, and having regard to the circumstances that prevailed in this case, I cannot say that the plaintiffs have established their charge of negligence against Mr Robinson

Lord Justice Romer said—

I turn to the case against the auditors, and, although we are differing from the learned Judge, I confess that it appears to me that the matter can be stated very shortly It is impossible, I think, to lay down any general rule as to what is the duty of an auditor in all circumstances and in all conditions One must know by whom the auditor has been appointed the circumstances in which he has been appointed, and the facts with which he has to deal, and it is then possible, no doubt, to say, as regards any particular circumstance, what the duty of the auditor was I mention that because this case has been presented to us as though Mr Robinson stood in the position of an auditor appointed by the shareholders of a limited company But I do not take that view at all I do not think he was appointed in pursuance of any statutory duty imposed upon the Commissioners to appoint an auditor He appears to me to have been appointed by them purely for their own purposes He really stood to them in the relation in which an auditor would stand to a firm of partners who appointed him auditor to audit their accounts But assuming he did stand in relation to the Commissioners in the same relation that an auditor appointed by the shareholders of a company stands in relation to them, as between them and the directors of the company, I still fail to see that he was guilty of any dereliction of duty It appears to me that an auditor, even an auditor in that position, has nothing to do with the policy of the board, that is to say, if the board choose to lend money to one person or another, it is not for the auditor to criticize their action by calling the attention of the shareholders pointedly to the fact that that particular loan has been made In the present case, when Mr Robinson discovered that the chairman of the board was indebted to the Commissioners in respect of rent, I will assume that it was his duty to let the Commissioners become aware of that fact But he would discharge that duty if he drew the fact to the attention of someone whose duty it was to communicate the fact to the board In the present case we know that when his own clerk informed him of this indebtedness of Mr Whitehead, and that the collector, Mr Taylor, inquired about it, Mr Robinson said that he told his clerk to go and see Mr Gardiner, who was the clerk to the Commissioners I understand Mr Gardiner to say that he was not, in fact, approached by Mr Robinson's clerk Mr Robinson had every reason to suppose that Mr Gardiner had been approached, because his own clerk told him what Mr Gardiner's reply had been Further than that, in the year 1930, Mr Robinson had a conversation with Mr Johnson, I think his name was who was a member of the finance committee, and discussed the matter with him and brought it to his attention, and further than that, Mr Robinson knew that every month there was brought before the finance committee a statement of debts outstanding Those debts appear to be in certain memoranda, but in those memoranda the debts were all lumped together, and it was only the total that appeared But Mr Robinson understood and believed that the detailed statements from which

those totals had been compiled, and which had been prepared by Mr Gardiner, the clerk, were before the finance committee In those circumstances I cannot see that Mr Robinson has been guilty of any dereliction of duty All that can be said is that he did not specifically report, did not specially call attention to, the fact that this debt had been incurred In the circumstances I do not think it is necessary or that it was necessary for him to call attention specially to the fact, having regard to the inquiries he had made and the answers that he had received I agree further that an auditor would be guilty of a dereliction of duty if, in preparing Balance Sheets for his employers, he includes as a good asset something that he knows is not, and if it could be shown that in this case Mr Robinson brought into the Balance Sheet as a good debt this debt of Mr Whitehead's company, which was not in fact a good debt, I agree that the plaintiffs would have just cause of complaint against him

But what are the facts? They are deposed to by Mr Robinson in his evidence, and it appears that he did seriously consider the question as to whether this debt of Mr Whitehead's company was a good one or not, and came to the conclusion, bona fide, no one doubts, that the debt was a good one In those circumstances he was not guilty of any dereliction of duty in allowing these debts to appear in the Balance Sheets as good debts If an auditor, when he has a list of debts before him, has in the case of a derelict company, to send for its Balance Sheets for the last year or so, and, in the case of an individual debtor to make inquiries through trade societies to try and get hold of a copy of the man's income tax return, the life of an auditor would not be worth living He has done his duty if, having no reason to suppose otherwise, he brings in the debts which the directors have allowed to be incurred, at their face value It is only when information comes before him which suggests that the debt is not a good one, that he must either set some reserve against the debt as being a bad one, or specifically call the attention of his employers to the fact that, although it is doubtful whether it is a good one or not, he has nevertheless included it in the balance sheet as a good one

In my opinion the plaintiffs have failed to show that Mr Robinson has been guilty of any breach of duty and, in my opinion, this action should be dismissed with costs

Lord Justice Maugham dealt with a point of great interest to auditors, i e the question of the amount of damage suffered, when he said—

I will add this, to which I think my brethren have not referred I do think it is worthy of remark that there is no evidence whatever as to damage having been sustained by the Commissioners by reason of the figure at which the debt due by Sellers & Son stood in the accounts of the plaintiffs The accounts may well have represented the assets as being, in some years, £60 or so too high and, at the end, about £175 too much so far as regards gas and rent due by Sellers & Son I am leaving out of account the other sums, because the auditors knew nothing about them I ask myself, what loss have the Scarborough Harbour Commissioners suffered by reason of the fact that their position was represented as being better during three years than it really was Mr Grant, in his argument, does not insist upon the view that some could have been recovered, it is his view that during these three years nothing could have been recovered from Sellers & Son, nor, I think he admits, from Mr Whitehead What

he does say I think, is that the Commissioners might very likely have turned Sellers & Son out of their occupation of the premises on the pier in respect of which the only debt we are considering was incurred With regard to that, I would point out that this rent was £11 4s per half-year The amount of the rent due in 1929 was £68 12s , it ultimately grew, as I have said, to a sum of about £175 Now, what reason has the court to suppose that the Commissioners would have turned out Messrs Sellers & Son from the premises had their attention been called more pointedly than it had already been called to the fact that rent was being unpaid? There is absolutely no evidence that they would have turned out Sellers & Son before the date when the auditor, Mr Robinson, insisted upon the meeting being called On the contrary, the evidence is all the other way, and for a very natural reason It appears that Mr Whitehead, whatever his other errors of judgment or duty may have been, had done a very great service to the Commissioners by getting rental from another source, and particularly from the lease of premises on the pier, and that the offices in question, with this rent of £11 4s per half-year, were being occupied during the material period in part for the Commissioners' own business In those circumstances, and in the total absence of any evidence to suppose the contrary, I should come to the conclusion that it is a mere speculation, ill-founded in fact, to suggest that the tenancy of Sellers & Son would be put an end to, and that accordingly the Commissioners might possibly—because it amounts to no more than that—have found some other tenant for these premises

On the whole, therefore, for those reasons, in addition to those already stated, I am of opinion that the action against the auditors wholly fails, and should be dismissed

This case was reviewed in a leading article that appears in *The Accountant*, Vol XCII, page 29, in which the conclusions to be drawn are ably summarized as follows—

The final result of the whole case appears to us to be satisfactory It is established once again that in a case where an audit is not ruled by statute, the duty of the auditor to his principal springs out of the contract between the parties An auditor is not to represent to his principal as true any matter which he knows to be untrue If any circumstance comes to his notice which throws doubt on the correctness of entries made in a statement of account, he must make a careful investigation and make careful inquiries of the responsible officials employed by the principal If the replies to those inquiries are satisfactory, and if there is no reason to doubt the integrity of the officials concerned, then there is an end of the matter The principal cannot expect, in the absence of special instruction, the auditor to act as a kind of deputy for the carrying out of duties which are laid on the principal himself or on his servants The whole key-note of the audit is "verification, not detection," and the *Scarborough* case has reaffirmed the general principle that an audit is not a roving commission, to detect this, that, or the other abuse which may have occurred, nor is it an indemnity to the principal against the results of his own mismanagement

Blue Band Navigation Co Case This is a Canadian case, in which the trustee in bankruptcy brought action

against the auditors, Messrs Price, Waterhouse & Co, upon the grounds that the auditors had been guilty of negligence, as the Balance Sheet included an item of $37,000 at its face value "without making any explanation or comment in connexion therewith in their certificate or report" In consequence it was claimed that the shareholders had been seriously misled and prejudiced

In the first Court the finding was against the auditors, but this decision was reversed by the Court of Appeal

A Mr Whittall, one of the two directors who were the effective management of the company, had a current account with the company His indebtedness to the company grew to $25,000 This amount was then transferred to the debit of the Western Trading Syndicate At the same time the syndicate was debited with $12,000 and Profit and Loss was credited under the heading of "Extraneous Profit"

It was alleged that the Western Trading Syndicate was a dummy of Whittall's, but this was not proved

Whittall refused to give the auditors any information as regards the syndicate upon the ground that these transactions were of an extremely confidential nature The auditors pressed for some verification of the value of this asset of $37,000, whereupon Whittall assumed personal responsibility by himself guaranteeing this debt At one of the annual general meetings the shareholders asked for particulars as regards the Western Trading Syndicate, when Whittall informed them that this debt was guaranteed by him Eventually the company failed to recover anything in respect of this debt

The Court of Appeal found in favour of the auditors upon the grounds that they honestly believed this debt to be a good one They had obtained Whittall's guarantee and they had no reason for suspecting that it was not a good one, if they had thought otherwise the case would have been different One of the appeal judges stated—"A court should be sure of its grounds before substituting its own views long after the event for those of the auditors formed at the time in the light of then existing facts"

This case again makes clear the fact that an auditor is not an insurer, he is not concerned with the wisdom or

unwisdom of an investment, and he is in no way responsible for management His responsibilities are confined to taking reasonable precautions, making proper inquiries, coming to an honest opinion and reporting it clearly to the shareholders

Republic of Bolivia Exploration Syndicate, Ltd Here it was held that auditors are prima facie responsible for *ultra vires* payments made on the faith of their Balance Sheets, but whether and to what extent they are responsible for not discovering and calling attention to the illegality of payments made prior to the audit must depend upon the special circumstances of each case

In this case certain payments were made, before the audit, for which there was no authority, this company being regulated by Table A (1906) Although these payments were *ultra vires*, the Court does not appear to have been satisfied that the company suffered actual damage through the auditor's default in not pointing out this fact in his report Therefore, in the special circumstances of the case, the action against the auditors was dismissed, but without costs, as the Court appears to have been far from satisfied with the manner in which the audit was carried out

Dumbell's Banking Co Ltd In this case the auditors, together with the directors, were prosecuted and sentenced to various terms of imprisonment, for concurring in the publishing of three Balance Sheets "which they knew to be false in material particulars, with intent to deceive and defraud the members, shareholders and creditors of Dumbell's Banking Company"

Wilde and Others *v* Cape and Dalgleish In this case the accountants were sued for negligence and breach of duty, the grounds being that they did not check the plaintiffs' Pass Book with the Cash Book, and thus failed to discover defalcations of the cashier, amounting to £1700 odd The point of the case was as to whether or not the accountants were instructed to carry out a full audit The case was settled by the accountants agreeing to judgment for £850 From this and the cases referred to in Chapter I, it will be seen how important it is that an auditor should have, in all cases, a clear and definite understanding with

his clients as to what exactly he is to do, and what ground he is to cover, especially when only a partial audit is required, or where an accountant is instructed to carry out accountancy work only Several accountants have had to pay damages in cases where the whole question has been as to what were the original instructions, and, therefore, what work they contracted to do

CHAPTER XII

THE LEGAL POSITION OF AUDITORS (*contd*)

Armitage *v* Brewer & Knott In this case damages were claimed against the auditors in consequence of frauds committed by an employee, and judgment for £1259 was given against the auditors This case is worthy of detailed study The frauds were perpetrated by a Miss Harwood, who had complete charge of the books, the payment of wages, and there was no system of internal check The main point of the case was whether or not the auditors had exercised reasonable care and skill

Part of His Lordship's summing up reads—

> However much it might be wrapped up the defendants' case came to this, that systematic fraud for two and a half years by one person could not be detected by the exercise of reasonable care on the part of the accountants His Lordship did not like to use strong language, but that appeared to him to be bordering closely on nonsense On the evidence it was an allegation which did not bear a moment's examination

In fact, Messrs Price, Waterhouse & Co had been called in to investigate the frauds, and Miss Harwood was prosecuted at the Central Criminal Court and pleaded guilty The importance of an auditor following up small discrepancies is clearly brought out in this case His Lordship stated—

> It was doubtless true that to detect required minute examination of a large number of documents, but that was exactly what the defendants undertook to do As to the suggestion that some things were too trivial to notice, audits differed greatly as to scope and special instructions A 6s 1d had been altered to 16s 1d That was passed in what purported to be a meticulous examination The most casual inspection would detect the discrepancy on the voucher, both figures were there His Lordship was struck by the audacity with which many of these frauds were committed It looked as though Miss Harwood had found that she had nothing very formidable to fear in the way of audit It was the duty of the auditor to bring that 10s —which was indicative not only of fraud but of forgery—at once to the notice of the principal That one piece of paper raised a grave suspicion It was of critical importance It was by little things like that that forgeries and frauds were found out

The main part of the fraud arose in connexion with the falsification of wages sheets and it was clear that had these wages sheets been examined thoroughly the fraud must have

been disclosed His Lordship stated "It was no use looking at such documents as were found here unless one did it with scrupulous accuracy" And, further, that "When there was something to make one uneasy His Lordship thought the defendants should have been doubly vigilant" And also that "it was clear that a good many documents were suspicious on their face and called for inquiry"

This case brings out clearly the vital importance of the exercise of vigilance and care in the vouching of documents

In *re* S P Catterson and Sons, Ltd In this case the liquidator of the company brought a summons against the auditor under Section 276 of the Companies Act, 1929

The facts of the case were that in the showroom of the company the system was that upon cash sales being effected a cash invoice was made out in an invoice book, these invoices being serially numbered One copy of the invoice was receipted and handed to the customer and the counterfoil remained in the invoice book Subsequently from the counterfoils the cash sales were entered in a daily cash sales book, the serial numbers being recorded and the total cash was handed to the manager who was one of the directors of the company

From time to time sales were effected on short credit terms when the same invoice book was used and the system was that in those cases where credit had been given the counterfoils were turned up or "dog-eared" When the customer paid, the system was that the counterfoil should be turned down The utilization of this same cash invoice book for both cash and credit transactions at once destroyed the system as the regular consecutive numbering of the counterfoils being accounted for in cash was broken The clerk in charge of the showroom effected the defalcation by misappropriating cash paid by short credit customers and, therefore, on receipt of the cash did not turn down these counterfoils In this connexion His Lordship stated "Now the evidence to my mind is clear that that system of using the invoice book for ready money transactions as well as for short credit transactions had been going on for years, and it is equally clear to me that that system and the so-called system of keeping a record of the transactions done on credit by turning up the invoice was also

known to the directors and had been known to them for years "

The auditors pointed out to the directors that the system was not a satisfactory one and they recommended improvements, but these recommendations were disregarded

His Lordship stated "It is clear that the unsatisfactory system employed in the showroom was clear to the mind of the auditor and that it was called by him to the attention of the directors, and that notwithstanding that fact they preferred, for some reason or another, to continue the system as it was I am not prepared to hold in those circumstances and on those facts that there was any duty upon the auditors to insist upon that system being changed It is not their business to tell the directors how to carry on and conduct their accounting system, they make their recommendations and, if they are not acceded to, the responsibility is not the auditor's responsibility, but it is the responsibility of the directors "

In reviewing the responsibility of auditors generally, his Lordship stated "The first fact which seems often to be lost sight of is that the primary responsibility for the accounts of a company is with those who are in control of the company, that is to say, the Directors, and in the case of the directors of this company, they were not a satisfactory team "

His Lordship stated that "I have no doubt as to where the primary responsibility for finding out the defalcation of this man Spicer lies It lies upon the shoulders of the man whose duty it was as a director of this company to collect from Spicer the cash that he received If that man had done his duty in any degree at all the frauds could not have been perpetrated in the way in which they were perpetrated", and he concluded by stating that, in his opinion, the auditor was an honest man trying to do his duty and that in view of all the facts of the case and the audit notes, that the applicant had "quite failed to satisfy me in respect of the matters charged that there was any negligence The result is that the application fails and must be dismissed "

A very interesting leading article on this case appears in *The Accountant*, Vol XCVI, page 290

City Equitable Fire Insurance Co, Ltd This case is of great interest to all practising accountants and is worthy of close study

Extensive frauds had been perpetrated by the chairman of the company, and the Official Receiver took action against several of the directors and the auditors

As regards the auditors, the charges were that they were guilty of negligence in respect of the audit by them of the Balance Sheets of the company for the years ending the 28th February, 1919, 1920, and 1921 The charges of negligence and breach of duty came under three heads—

(1) That the debt due to the company from Ellis & Co, the stockbrokers of the company—Mr Bevan, the chairman, being a partner in that firm—and the debt due from Mr Mansell, the general manager, were misdescribed by being included under "Loans at call or short notice" or "Loans," or, in the case of part of Ellis & Co 's debt, under the heading of "Cash at Bank and in hand " Further, that the auditors failed to disclose to the shareholders the existence of these debts

(2) Their failure to detect the fact that much larger sums were in the hands of Ellis & Co at the date of each Balance Sheet than were so included

(3) Their failure to detect and report to the shareholders the fact that a number of the company's securities which were in the custody of Ellis & Co were being pledged by that firm to its customers

Generally speaking, the Judge found that the auditors had displayed great skill, care, and industry

As regards the first charge, the position was that the balances owing to the company from Ellis & Co, in 1919, amounted, according to the books, to £51,423, and rose in 1921 to £423,650 The amount due from Mansell was £6,225 in 1919 and in 1921 had increased to £96,233 In the 1919 Balance Sheet these sums were included under the heading of "Loans at call and short notice," and in the 1921 Balance Sheet £350,000 owing by Ellis & Co, and the £96,233 owing by Mansell, were included under the heading "Loans," and £73,650 owing by Ellis & Co, on Investment Account, was included as "Cash at Bank and in hand"

His Lordship held that it was not the duty of the auditors specifically to draw the attention of the directors and the

shareholders to these debts Even if these items were incorrectly described in the Balance Sheet—and in the case of the debt of £73,650 classified as "Cash at Bank and in hand," the Judge held that this was a misdescription—any such misdescription did not involve damage to the company

The auditor, however, must not include at its face value a debt that is not a good one, but in this case the credit of Ellis & Co at that time was good, and, further, the company held collateral security As regards the debt due from Mansell, at that time there was no reason to suppose that this was not a good debt In this case, however, the auditors were informed that security had been given and Bevan certified that he held that security As regards the acceptance of this certificate by the auditors, the Judge held, as will be seen later, that they should have called for the production of these securities

As regards the second and third charges, these involved "window dressing" operations carried out by Bevan each year, the charge being that the auditors should have detected these and thus have discovered the extensive frauds

The "window dressing" operations were carried out each year by a pretended purchase of Treasury Bonds just before the date of the Balance Sheet, followed by a pretended sale just after that date In this way, at the date of the Balance Sheet, the debt due from Ellis & Co was materially reduced, and the gilt-edged securities shown in the Balance Sheet increased

These operations were effected by Ellis & Co giving an order on their own behalf to another firm of brokers for the purchase of the Bonds, at the same time they arranged for the brokers to advance to Ellis & Co the sum involved, the Bonds being given as security for the loan A few days afterwards Ellis & Co gave an order for the sale of the Bonds, when the loan would be repaid

Upon the purchase of the Bonds, Ellis & Co debited the company, and in the books of the company the corresponding entries were made

Part of the charge was that the auditors should have noticed from year to year that the Bonds purchased just before the date of the previous Balance Sheet were sold immediately afterwards in the succeeding financial year,

when it would have been obvious that these were "window dressing" operations This part of the charge failed

The second part of the charge was that the auditors should have called for the production of the Treasury Bonds shown by the company's books to be held at the date of the Balance Sheet, in fact, the auditors accepted certificates from year to year from Ellis & Co that they held these bonds for the company His Lordship held that the auditors should have called for these securities and that they were not entitled to accept the certificate of the company's stock-brokers If this had been done the fraud must have been revealed, as Ellis & Co could not have produced the Bonds, as they were charged to the brokers against the loan by them to Ellis & Co It was held, therefore, that in this direction the auditors were guilty of a breach of duty and of negligence, and they would have been held liable in damages, except for the fact that one of the company's Articles of Association provided that the directors, auditors, and officers of the company should be held indemnified by the company, except in the case of wilful negligence His Lordship held, therefore, that as the negligence of the auditors did not amount to wilful negligence, they were protected by the Article and therefore escaped liability. Auditors can no longer be protected by a similar Article See Companies Act, 1929, Section 152

In the course of the evidence it was established that in cases where the securities of a client were held by a bank of standing, it was the custom for auditors to accept the certificate of the bank as verification of such securities His Lordship referred to this custom and questioned its soundness This point, however, was not decided in this case, but His Lordship appeared to be of the opinion that in all cases an auditor should personally inspect all securities, where-ever or by whomsoever held

Newton *v* Birmingham Small Arms Co. In this case the company had altered its articles by Special Resolution, giving the directors certain powers to create an internal reserve which was not to be disclosed on the company's Balance Sheet The auditors were to be entitled to examine these transactions and to see that this reserve had been properly applied for the purposes of the company, but they

were not to disclose to the shareholders any information as regards this reserve It was held that the terms of this Article, whereby the powers of the auditors were limited, were *ultra vires*

In the course of his judgment His Lordship stated—

It is, I think, inconsistent with the Act of Parliament that the auditor should be bound even when he thinks that the true state of the company's affairs is affected by facts relating to the internal reserve fund, to withhold all information with regard to the same from the shareholders If, for instance, the directors had invested the internal reserve fund upon investments which might involve the company under certain circumstances in enormous loss, the Act, I think, requires that the auditor shall be at liberty and be bound to report that fact Any regulations which preclude the auditors from availing themselves of all the information to which under the Act they are entitled as material for the report which under the Act they are to make as to the true and correct state of the company's affairs are, I think, inconsistent with the Act

Part of this judgment has often been quoted as justification for an auditor passing a Balance Sheet that understates the true position of affairs, and no doubt accounts for the introduction into the report adopted by some auditors of words indicating that certain assets are undervalued as, for example, "The shares and other investments of the company possess, in the aggregate, a value largely in excess of the figures shown in the Balance Sheet" The part of the judgment referred to reads as follows—

The concluding sentence of Section 23 requires that the auditor shall state whether the Balance Sheet exhibits a true and correct view of the state of the company's affairs as shown by the books Sir Robert Finlay argued that these words are satisfied if the auditors report that the Balance Sheet does not exhibit a true view and that the statute does not, in these words, say that they shall report what is the true view This is logically true as regards the language, but, in my judgment, the statute is saved from the reproach of having achieved no more than this impotent result by words earlier in that section, which provide that the auditors are to report to the shareholders on the accounts A report upon the accounts involves a report of the result of the accounts, and this necessarily involves, as matter of substance if not of form, the statement of a Balance Sheet or the equivalent of a Balance Sheet There are, I agree, in the Act of 1900 no affirmative words to the effect of what I am about to state, but I think the language of the Act is sufficient to show that by implication it requires that there shall be annually an audit of accounts resulting in a Balance Sheet, to the accuracy of which the auditors shall speak The special resolutions in the present case provide that the Balance Sheet shall not disclose the internal reserve fund It must therefore omit on the assets side of the Balance Sheet the assets which make up the amount standing to the credit of that fund and the contra item—namely, the credit balance of the fund—on the liability side The result will be to

show the financial position of the company to be not as good as in fact it is If the Balance Sheet be so worded as to show there is an undisclosed asset whose existence makes the financial position better than shown, such a Balance Sheet will not, in my judgment, be necessarily inconsistent with the Act of Parliament Assets are often, by reason of prudence, estimated and stated to be estimated at less than their probable real value The purpose of the Balance Sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not or may not be better

Royal Mail Steam Packet Company Case In this case the chairman of the company, Lord Kylsant, and the auditor, Mr Morland, were criminally prosecuted under Section 84 of the Larceny Act, 1861 Lord Kylsant was charged in respect of the company's accounts and annual reports for the years 1926 and 1927 on the grounds that he knew them to be false and that the annual report concealed from the shareholders the true position of the company with intention to deceive The auditor was charged in respect of these two counts with aiding and abetting Lord Kylsant to commit the offence

Lord Kylsant was further charged with publishing a prospectus inviting the public to subscribe for Second Debentures in the Royal Mail Steam Packet Company whilst he knew the prospectus to be false in a material particular and that it concealed the true position of the company with the intention to induce persons to subscribe for the debentures The auditor was not charged on this count

The R M S P Co is a company formed under a royal charter, and not, therefore, subject to the Companies Act, but it is governed by the terms of its charter, which, as regards the accounts and audit, follows closely the terms of the Act

This case is an extremely important one, and every accountant should study it in detail, as it raises many points of vital importance, and this case has had a profound influence on accountancy practice

The circumstances of the case briefly are that the company had made substantial profits during the war period and up to the beginning of 1921, after which time owing to the slump in shipping all over the world, the company's earnings showed a considerable falling off During the years from 1921 to 1927 inclusive the Profit and Loss Accounts were credited with special items amounting to approximately £5,000,000

These special credits were mainly in connexion with the War and represented Excess Profits Duty recoveries, obsolescence and deferred repairs allowances, together with excess taxation reserves and bonuses from subsidiaries paid out of past profits As a result of the crediting of these items to the various Profit and Loss Accounts during the whole of this period, the company was enabled to pay its debenture interest, preference dividends, and dividends on its ordinary shares

In this case it was not contended that these credits were improper ones in any way In his summing up, His Lordship said—

> They were, as you see, certainly not current earnings and they were no criterion of the earning capacity of the company at all in the period in question It is a fact that whether they are called reserves or not, you will have to consider whether these sums of money are not, for the purpose of the question you are considering, just as if they had been reserves, although they were as you see from this account from time to time, becoming available for use
>
> Then you will consider this question, whether the essence of the matter is simply this, that the shareholders ought to have been told that the company was being kept going by means other than current earnings

The only charge as regards the accounts was made in respect of the years 1926 and 1927, as to which His Lordship in his summing up stated—

> In 1926 you get a position which according to this table shows a surplus on the whole of the position of £628,535 That surplus is only obtained by bringing in excess profits duty £550,000, income tax reserves £175,000, profit on the Nelson Line and the general reserve fund £350,000 That is the first of the two years with which we are concerned
>
> In 1927 you have a very similar position subject only to this, that the excess profits duty is finally exhausted in 1927, and the income tax reserves, profit on steamers and premises sold, corporation profits tax, and sundries make a total of £540,386 Then in that year there was also brought into the account the bonuses of £300,000 obtained from the two Nelson companies under circumstances which I am sure you fully remember The Nelson companies had been prosperous, they had had this money available and they paid it over in the form of bonuses which they declared in that year

In the accounts of the R M S P company the balance available was described as "Balance for the year, including dividends on shares in allied and other companies, adjustment of taxation reserves less depreciation of fleet" Up to 1923 the words "Profit for the year" had been used, in subsequent years the words "Balance for the year" were

ntroduced In 1925, at the suggestion of the auditor, the words "Adjustment of Taxation Reserves" were included in his description (The Balance Sheet and Profit and Loss Accounts for 1926 and 1927 are reproduced in *The Accountant* of the 25th July, 1931)

The following is an extract from the prospectus—

> Although this company, in common with other shipping companies, has suffered from the depression in the shipping industry, the audited accounts of the company show that during the past ten years the average annual balance available (including profits of the Insurance Fund) after providing for depreciation and interest on existing debenture stock has been sufficient to pay the interest on the present issue more than five times over
>
> After providing for all taxation, depreciation of the fleet, etc , adding to the reserves, and payment of dividends on the preference stocks, the dividends on the ordinary stock during the last seventeen years have been as follows

The actual dividends for the seventeen years in question were set out and the average profit shown as available for the ten years upon the basis indicated did represent a sum sufficient to pay interest on the debentures being offered more than five times over

As regards the prospectus, in his summing up His Lordship said—

> If you take an average you may, within the period over which the average is taken, have very diverse figures and I should imagine—I do not know, but one feels—that if ever I venture on a prospectus in future I shall look very shyly indeed at any reference to averages Indeed, I am not sure that under the new Act such a thing can be done

And further—

> It does look as if it was carefully arranged and carefully prepared so as to put the best face on the position and to do so by stating a series of matters, each one of which was strictly accurate, but there are certain relevant matters which are crucial if the investor was to know the true position of the company For instance, the circumstances under which dividends had been paid during all those years and the use of those credits or reserves which we have heard about and, if it was realized by Lord Kylsant, the possibility of the guarantee under the Trade Facilities Act not being renewed These and other matters which are obvious were not stated This is one of those difficult cases, but not impossible cases, which have occurred from time to time in the course of company transactions, where a document has been put forward in order to be acted upon (prospectuses and other things) and put forward in such a form that although it stated every fact correctly fact by fact, everything was correctly stated by the card, and yet the true effect of what was said was completely false and completely misleading
>
> Now that result might be achieved with the best of intentions and by

a man who while his mind was fixed on attaining his object and floating an issue, and while he was in a sense thinking of what was best to achieve that object, was not thinking and was not conscious to himself that he was going to mislead people, and that he was going to induce them to subscribe to the issue under the belief which was completely false and completely delusive

The part of the case in which all accountants are particularly interested is that as regards the auditor, and the main point at issue was as to whether clear and specific indication should have been given in the accounts as to the amounts of the special credits which were being brought into the Profit and Loss Account and whether the words "Adjustment of Taxation Reserves" was a sufficient indication

It is a common practice for abnormal credits to be taken into the Profit and Loss Account, and it was brought out clearly in this case that from the auditors' point of view this was a question of degree, that is to say, that up to a certain point such credits might be considered quite in order and require no comment from the auditor but that beyond a certain point such credits could not be accepted without qualification The difficulty is that it is impossssible to define this point In his evidence the President of The Institute of Chartered Accountants stated that "From the accountant's point of view it is a matter entirely of degree," and when asked whether there did not finally come a stage when there must be not merely an indication but a perfectly precise phraseology, when nobody can make any mistake about it, he said "I should think so, it depends on the circumstances, one cannot generalize exactly"

In his summing up, His Lordship pointed out that—

In the case of Mr Morland it is obvious enough that in the year 1926 when the accounts of 1925 were being dealt with he was not satisfied with the position, because he thought that some words ought to be added to intimate to the shareholders that the moneys which we know were being used were being used in order to produce the balance which appears

That being so, he thought, as indeed he has admitted, that without some qualification or another he ought not to give the certificate The qualification which he suggested and which he put in was those words you must all be tired of hearing, "Adjustment of taxation reserves" Mr Morland says that that satisfied his doubts, he thought then that he had done enough to cure the defective character of the Balance Sheet or Profit and Loss Account with those words If he was right in that, if he had discharged his duty sufficiently and properly, then it seems, on any view, that the matter is or ought to be, at an end

If, on the other hand, he was wrong in this sense that in a civil action

or in an action against him for not showing due care and skill he would be held liable as a defendant because he had broken his duty and not fully discharged his office, then again his liability would be a civil liability in damages That is assuming against him that he ought to have done something else before he signed the certificate, that he ought to have taken some drastic step and some more effective step in order to bring to the minds of the shareholders the true position of the company's affairs and it may well be that he did not discharge his duty efficiently and properly

His Lordship continued by pointing out that what the jury had to consider was whether the auditor had committed a deliberate and conscious act with a view to deceiving the shareholders Three accountants gave evidence, including the Presidents of The Institute of Chartered Accountants, and The Society of Incorporated Accountants and Auditors, and stated that they would have been prepared to sign the auditor's report in the same form as was adopted in the case of the Balance Sheets in question

The case turned upon whether there was fraudulent and criminal intent His Lordship stated—

If you think that he only committed an error of judgment and something which fell short of his duty, you have still to consider, before you consider the question of intent at all, did he appreciate that he was doing something wrong or did he honestly believe that he had discharged his duty by putting into the Balance Sheet in that and subsequent years those mystic words which are said to be so clear, but which may or may not be clear, "Adjustment of taxation reserves"?

Supposing he honestly thought that that was enough, then on any view of the case you could not find him guilty of fraudulent intent However mistaken a man may have been, and however unfortunate the circumstances of his mistake may be, that does not constitute criminal intent or a criminal offence

Lord Kylsant and Mr Morland were both found not guilty on the first two counts, that is as regards the Balance Sheets of 1926 and 1927, but Lord Kylsant was found guilty on the third count, that is as regards the prospectus

The whole of this case is well worthy of the closest study by all accountants and students, as it raises questions of the utmost importance, in particular as regards the formation and utilization of undisclosed reserves This matter is one upon which the profession has been in serious doubt for many years and in view of its importance it has been thought advisable to set out in full the part of his Lordship's summing up which deals with this subject

A great deal has been said about the keeping of secret reserves and how far that is or is not permissible under the Companies Act or under the special charter of the Royal Mail Steam Packet Company

We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice We have heard a great deal about what is often done in practice and it may be reasonably and properly done Questions may arise some day and possibly will arise, in some appropriate proceeding in order to find out and elucidate these very special matters

It was said by a very learned judge on one occasion, by way of observation and not by judgment, that a company, that is to say the shareholders, could not complain if the position of the finances of the company was better than the accounts disclosed That has been quoted from time to time as justification for this method of keeping reserves secret But there may be very great evils if those who have the control and management of the company, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, if very large portions of the company's assets are left in the secret disposition of the managing authority

It may work well in many cases, no doubt it does It is a practice which is being followed, no doubt, by many concerns of the highest standing On the other hand, it may be the subject of almost intolerable abuse Such a system may be used to cover up negligences, irregularities, and almost breaches of faith It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it all? How can they consider whether it is something which they are satisfied with or which they are not satisfied with?

Now, taking this case without entering into the thorny question as to whether you have here anything which can be called reserves or not, you have here a series of large sums of money the nature of which and the propriety of which have remained secret from the shareholders, and the use of which has remained secret from the shareholders if you exclude certain things which appeared in the three last Balance Sheets with which we are concerned

Now what has happened as the result of that? We know and there does not seem to be any dispute about it now—when I say "We know," this is how I understand the evidence, you may view it differently—we know that there were Balance Sheets and Profit and Loss Accounts published for a period of seven years which did not disclose one way or the other whether the company was earning any profit or not During those seven years there was expended out of those items which were mainly connected with the War, a sum of no less than five million pounds —not out of current earnings at all, but out of these items which in the main, not quite wholly, but in the main, arose out of the War

During all that period the shareholders were told nothing, and they drew their dividends presumably in the simple faith that all was well with the condition of the company

It is said "Very well, they got their dividends" It is said "Times might have changed, and although these items of income came to an end, others might take their place and conditions might improve " On the other hand, surely if the shareholders had been told (I do not say who is responsible for the moment) that this company had no earnings, because

earnings are the life blood of a company—a company cannot go on indefinitely using its capital assets unless it is earning—if they were told that this company had no earnings, surely they might have taken steps, as could be done and has been done in other cases

As soon as the shareholders became aware of the condition of the company surely steps might have been taken if the shareholders were so disposed, and certainly they should have had the opportunity of taking steps, for the reconstruction and rearrangement of the company's affairs, the cutting down of expenditure, the reduction of services and all those things which have to be done when a company is not paying its way The sooner that is done the better, and the better hope there is of the company surviving the troublous times

It was never brought to the shareholders' knowledge what the position was It may seem incredible that this could go on in a big company for all those years, but so it was, and then eventually at a period which is outside the period we are concerned with something had to be done and some steps had to be taken

It is a little astounding and one cannot help wondering whether those who manage big companies do not forget sometimes that the body of directors of a company are the agents and the trustees of the shareholders, that they owe full information, subject to proper and reasonable commercial necessity, they owe them full information, and it is their interests that they have to study, they are not to regard shareholders as people who may look up if they are not fed, they are the people whose money they are using, and it is to be remembered that a joint-stock company is a creation of law

A joint-stock company has the enormous advantage of limited liability and the legislature has intended, it seems to me, although by halting steps, to secure that those who enjoy those privileges of limited liability and who control and manage joint-stock companies should be subject to some condition as to publishing their accounts at least to the shareholders and at least to those who are entitled to be summoned to general meetings

The law has recently been, I was going to say, improved, but it has recently been altered in the recent Act of 1929 For the first time that has provided for the sending to shareholders of a Balance Sheet and a Profit and Loss Account in every year and there are penalties imposed upon directors who do not do that, and the Balance Sheet must contain a summary among other things of the liabilities and assets, together with such particulars as are necessary to disclose the general nature of the liabilities and assets of the company, and to distinguish between the amounts respectively of the fixed assets and the floating assets, and state how the values of the fixed assets have been arrived at

It further provides that there is to be a report by the directors with respect to the state of the company's affairs and the amount, if any, which they recommend should be paid by way of dividends and the amount, if any, which they propose to carry to the reserve fund, general reserves, and reserve account shown specifically on the Balance Sheet, or to the reserve fund or general reserve or reserve account to be shown specifically on a subsequent Balance Sheet

It may be said that that does not in terms prohibit the creation of any reserve which is not shown specifically on the Balance Sheet, and it may be said that in a matter of domestic concern like the keeping of reserves by appropriate regulations the shareholders may agree to a reserve being

accumulated, the exact amount of which is not specified in the Balance Sheet or the Profit and Loss Account That is a question which no doubt will require very careful consideration in some future case It does appear to me, as at present advised that the terms of the sections which I have read cannot possibly justify the omission of any amount of any reserve from the Balance Sheet and the Profit and Loss Account altogether, and at the moment (and I am very anxious not to be more precise than I feel I ought to be, because I feel I ought not to be very precise about this) there may be some justification for the maintenance of an undisclosed or secret reserve if the fact that there was such a reserve was clearly specified somewhere in the report, so that the shareholders could know, and if the majority of them desired to insist on its disclosure and its amount and utilization, they could do so However that may be, it is clearly the intention of these sections that the accounts of companies in future should be published with greater particularity and with greater information to the shareholders

Then there is the question of the auditor, because, as you will remember, the law requires the appointment of an auditor, who is the servant of the company, and his duty is to report to the shareholders, on proper examination, on the accounts which the directors are going to present to the company

The law does not impose an impossible burden on auditors, it does not make them insurers, it does not require of them the skill and vigilance which is beyond their power, but it does require them to report, and the report on the accounts would certainly include a very careful investigation of the Profit and Loss Account as one of the accounts, even if it is not expressly covered in the certificate, which is generally accepted as a complete report

Then they have to give a certificate as to whether in their opinion the Balance Sheet referred to in the report is properly drawn up so as to include a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them

Now if the account on which the dividends are being paid, or if the account on which the current expenses of the company are being met is being fed by undisclosed reserves, it seems to me very difficult to see how the auditor can discharge his duty of giving a true and correct view of the state of the company's affairs without mentioning and drawing attention to this fact, which may be of the most vital importance as indicating the state of the company's affairs

No doubt an auditor, in his very delicate and difficult duties, must use a certain amount of discretion, but whatever discretion he may feel that he is justified in exercising within the limits of what is reasonable, he must remember that he is under a statutory duty and that he may come under the penalties of the law if he fails in that duty, at least in specific ways, which I need not trouble about at this moment

Note The quotations given above have been taken from the report of the case appearing in the *Financial Times* 30th and 31st July 1931

From a consideration of the above it appears to be doubtful whether in the future the creation of secret reserves will be accepted, and particularly that if secret reserves are

drawn upon for the purpose of augmenting current income that grave risks will be involved if these facts are not disclosed

Conclusions

The Conclusions to be drawn from the various cases upon this subject would appear to be as follows—

(1) An auditor must honestly satisfy himself that the accounts show a true and correct view of the financial position of the concern whose accounts he is auditing

(2) He must examine the books, and satisfy himself that the books are correct, therefore, for this purpose he must test the books with vouchers and original records, and make proper inquiries

(3) It is not part of an auditor's duty to take stock, and he is entitled to rely upon the certificate of a responsible official, but he must exercise reasonable care and skill in testing the correctness of the stock

(4) An auditor is entitled to rely upon the opinion of experts where special knowledge is required

(5) An auditor need not necessarily be suspicious, but where his suspicions are aroused he must exercise all reasonable care and skill before he satisfies himself that all is in order

(6) It is no part of an auditor's duty to give advice

(7) If the auditor is not satisfied upon any material points, he must report clearly to the shareholders, in the case of a company, or to the partners in the case of a private firm

(8) The auditor must verify the existence of assets, so far as is reasonably possible

(9) In the case of a company, an auditor must see that the provisions of the Memorandum and Articles of Association are carried out

(10) If an auditor is negligent or does not exercise proper care and skill, he may be held liable in damages if it is proved that his client has suffered damage which otherwise would have been prevented

(11) As to what is reasonable care and skill depends upon the circumstances of the case, and also upon the general standard adopted by the profession

(12) In the case of private firms, it is of the importance that the exact scope of the auditor's (with his client should be recorded in writing

(13) Auditors will not be held liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion, and when these frauds have been perpetrated by tried servants of the concern

(14) If an auditor wilfully certifies accounts, knowing them to be false, he may be held criminally liable

(15) In the case of secret reserves, in view of the judge's pronouncement in his summing up, in the *Royal Mail Steam Packet Co* case, it is open to question whether in the future the creation of secret reserves to a material extent will be accepted as being in order, and in cases where secret reserves are being utilized to augment current earnings, in view of this case, it is clear that an auditor may be incurring considerable risks if he allows this to be done without the fact being made clear on the accounts

(16) Conservative valuation of assets and the provision for known liabilities the exact amount of which has not been ascertained, do not, in the author's opinion, represent the creation of what is understood by the term "Secret Reserve"

(17) The inclusion of free reserves amongst current liabilities does represent the creation of a secret reserve In these circumstances, in the author's opinion, the auditor should insist upon these reserves being separately shown or the fact being made clear that such reserves exist and are included with the current liabilities

(18) The auditor is responsible for the Profit and Loss Account and must see that it does give a fair view of the earnings of the period and therefore that the Profit and Loss Accounts from year to year are prepared upon a consistent basis Further, the Profit and Loss Account must not be worded in such a way as to give a false impression

(19) If current earnings are bolstered up by means of abnormal receipts or transfers from reserves created in past years the auditor should insist upon these items being separately shown or the fact being made clear that such items have been included with the current earnings

(20) In the case of a holding company, dividends received from subsidiaries and which are paid out of profits earned before the acquisition of the shares by the holding company represent capital, and must not therefore be credited to the Profit and Loss Account of the holding company If such dividends were credited to Profit and Loss Account, then it would be the auditor's duty to point this out in his report to the shareholders

(21) If dividends received from subsidiaries have been paid out of profits earned in preceding years and the amount involved is sufficient in amount to make the position shown by the holding company's accounts misleading, then it would be the duty of the auditor to make this fact clear in his report to the shareholders

(22) The conduct of the directors of a company is no answer to any breach of duty by the auditors, although it is a circumstance that will be taken into consideration by the Court

This question of the auditor's legal responsibilities is one of supreme importance to every practising accountant, it is however a most difficult one The auditor's responsibilities are not clearly defined in the Acts and the principles evolved by case law are in several directions conflicting

In the case of a company, the auditor's responsibilities are governed by statute, and it is impossible for the auditor to limit his responsibilities In the case of a private concern, the auditor's responsibilities are governed by the terms of the contract with his client and therefore his responsibilities can be limited by agreement, but in practice it is feared that in many cases there is no written evidence of the exact terms of the contract This position is fraught with grave danger, and in every case the practitioner is strongly advised to see that the exact terms of the contract are clearly understood by both his client and himself, and that these terms are recorded in writing

In the event of a loss through fraud occurring and which remained undetected by the auditor he may be placed in a position of grave difficulty It is so easy to be wise after the event and to see what audit tests must have revealed the fraud On the other hand it is so difficult to define exactly

what is reasonable care and skill, which is governed by the general standard of the profession In a case before the courts expert evidence would be called, but here again the expert would have knowledge of the exact form the fraud took, and it is therefore very easy to see what checks should have been applied in order to detect the fraud and to form the opinion that one would without question have adopted them

In the case of a fraud the client is naturally angered at his loss, and often vents his wrath upon the auditor for not having discovered it If a charge of negligence is made the auditor's professional reputation is at stake, and therefore it becomes a matter of vital concern to him

The risks involved are considerable and although the particular business may be small, if the auditor is held to be guilty of negligence, the damages assessed by the Court may be substantial in amount It has therefore become a common practice for practitioners to cover this risk by insurance, and this is a necessary and prudent precaution

From an auditor's point of view, the most difficult cases are those that turn upon the point as to whether the form in which the accounts have been presented is misleading or not The profession has not established a complete set of principles that can act as a guide to the practitioner, and it is doubtful whether it will ever be possible to establish principles that will apply to every case that may arise in practice In these circumstances it must be a question of the auditor's individual judgment, but no system of education and training can ensure that every member of a profession will be possessed of a sound judgment, which must be based upon experience backed by a sound and exhaustive training, but at the root it is largely dependent upon those personal characteristics that are so difficult to define but which some possess, whilst others can never acquire

The guiding principle upon which every auditor should act is that he should never give an unqualified report in respect of any Balance Sheet that in his opinion gives a view of the position of affairs that is calculated to mislead He must therefore be completely satisfied that the accounts present an honest view of the state of affairs of the particular concern

In conclusion, it may be said that it is very unlikely that

an auditor will be held personally liable provided he is possessed of the requisite professional skill, and that he honestly exercises such skill in all cases, taking every reasonable precaution to satisfy himself upon every point, before he certifies the accounts, and, in the event of his being dissatisfied upon any material point, if he reports clearly in his audit report to this effect It is thought that no better short definition of an auditor's duties can be given than the following, which is part of the judgment in the *London and General Bank* case—

> Such I take to be the duty of the auditor, he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true

The *Royal Mail Steam Packet Co* case focused, as never before, the whole attention of the profession upon this vital question, and the International Congress on Accounting held in London in 1933 gave the profession an opportunity to consider this problem exhaustively Every accountant and student should study the papers on "The Auditor's Responsibility in Relation to Balance Sheets and Profit and Loss Accounts," and the subsequent discussion which appears in the published proceedings of that Congress These papers also appear in *The Accountant* for 1933, Vol LXXXIX The paper delivered by Mr Henry Morgan is a brilliant review of the whole position, and though all will not agree with every one of his conclusions and recommendations, yet none can fail to be deeply impressed by the soundness of the general principles upon which the whole of his arguments are based

From the discussion upon the three papers it is evident that there were divergent views but referring to this fact the Chairman, Mr H L H Hill, struck a true note when he said "What has impressed me, however, more than anything else is the fact of our unanimity in ideals and objectives, before which the importance of agreement as to methods of attaining them sinks into insignificance I am certain that if and as long as we retain our determination to serve as effectively as we possibly can our fellow men in all countries, and in all humility and with singleness of purpose explore every avenue that may lead to this goal, our efforts will not be in vain"

CHAPTER XIII

THE FORM OF PRESENTATION OF THE ACCOUNTS OF HOLDING COMPANIES

The Outlines of the Holding Company Type of Organization

ONE of the most marked developments in industry and commerce in recent years has been the advent of the holding company, that is an organization comprising a parent company which holds a controlling interest in one or more subsidiary companies and in some cases sub-subsidiary companies

Control is effected by the acquisition of a sufficient number of shares in each subsidiary to give the holding company more than 50 per cent of the voting power, or, where the holding company has power directly or indirectly to appoint the majority of the directors of the subsidiary and thus influence the policy of that company

In this way the holding company may control a large group of companies and there are many such organizations to-day of an international character and comprising a large number of companies in countries all over the world

From the commercial point of view there are many advantages in this type of organization, and in the writer's opinion it is a natural development the benefits of which experience has proved

On the other hand, as is generally the case, there are weaknesses and one of the great difficulties is that this type of organization raises accounting problems of considerable complexity, in particular as regards the form of presentation of the holding company's accounts

This problem is of great public interest, and one which is in no small measure exercising the mind of the accountancy profession at the present time

This form of organization is capable of being improperly used as a cloak to hide from shareholders the true position of the combine in which they are interested and there have been grave abuses and spectacular crashes that have

shaken public confidence It is for this reason that this problem has loomed so large in recent times

This subject was considered most thoroughly at the fifth International Congress on Accounting held in Berlin during September, 1938 Readers who are interested in this problem are strongly advised to study the various papers submitted at that Congress and which appear in *The Accountant*, Vol XCIX The paper submitted by Mr Chas J G Palmour (*The Accountant*, Vol XCIX, page 493) is a brilliant epitome of the various papers and gives a remarkably clear picture of the views, upon all of the principal factors in connexion with this important problem, of the many countries represented at the Congress

At the outset the writer wishes to make it clear that the views here expressed are his own and not necessarily those of the board of his company Furthermore, in order to illustrate various points it is proposed to use the 1937 accounts of the Dunlop Rubber Co Ltd In doing so, however, it is not suggested that the form of presentation of these accounts represents the final solution of this vexed problem, they are merely used to illustrate how that company has attempted to overcome the various difficulties involved in this question

The General Situation and the Principal Complications and Difficulties

In the space available it is not possible to deal with all the accounting problems that arise in connexion with holding companies It is proposed, therefore, to deal with the general form in which it is suggested the accounts of a holding company might with advantage be presented

In the first place, however, it may be helpful to endeavour to make clear the general situation and the principal complications and difficulties in connexion with this problem

The holding company itself and each of the subsidiary and sub-subsidiary companies is a separate legal entity Each company therefore has its own board of directors, is a self-contained unit and operates under the company laws of the country in which it is registered in exactly the same way as any other company

The claims of creditors of each subsidiary company can legally be enforced only against the assets of that company and such creditors have no claim whatever against the assets of the holding company or of any of the other companies within the combine unless such debts have been guaranteed by another company within the group In practice, in order to preserve its goodwill, a solvent holding company would not usually allow a subsidiary company to default and would in all likelihood provide funds in order to satisfy the creditors of an insolvent subsidiary, but as already stated the legal rights of the ordinary unsecured creditors of a subsidiary are confined to the assets of that company

In order to comply with legal requirements, each of these companies must prepare its own accounts and submit them in the ordinary way to its shareholders in general meeting

It is important to bear in mind that the various individual companies within a combine are not branches of one legal entity embracing them all The connexion is by means of shareholdings, i e the holding company is merely a majority shareholder in each of the subsidiaries, in addition to which some of the subsidiary companies may in turn be majority shareholders in sub-subsidiary companies

In the Balance Sheet of the holding company its interest in the subsidiaries is represented by investments in and advances to the various subsidiary companies These investments and advances under the Companies Act, 1929, must be separately stated in the holding company's Balance Sheet

A holding company, for trading reasons, may be interested in a company, but, whilst holding a substantial interest therein, such interest may be only 50 per cent or less Such companies are commonly known as associated companies In these circumstances the holding company is not in a position to exercise effective control and is either a 50 per cent or merely a minority shareholder

It will be appreciated that the holding company may have a large family including children, grandchildren, and even great-grandchildren If, further, this large

family is scattered all over the world, it will be appreciated that it requires an extremely sound and efficient organization in order to exercise effective control, and a vital part of that organization will be an efficient accounting system

As regards the form of presentation of the accounts, there are no particular points in connexion with the accounts of the subsidiaries, but many difficult and complex points do arise as regards the accounts of the holding company itself As examples of the accounts of subsidiary companies in Appendix A will be found the Accounts of Dunlop Cotton Mills Ltd and Dunlop Plantations Ltd

The Provisions of the Companies Act, 1929, as Regards Holding Companies

The Companies Act, 1929, contains certain provisions dealing specifically with the accounts of holding companies But the general opinion, the writer suggests, is that these provisions by themselves are inadequate for solving this complicated problem

Under Section 126 it is provided that there shall be annexed to the holding company's Balance Sheet a statement signed by two of the directors stating how the aggregate profits and losses of the subsidiary companies have, so far as they concern the holding company, been dealt with in the accounts of the holding company

This statement must also state to what extent provision has been made for the losses of subsidiary companies either in the accounts of those companies or of the holding company or of both Further, it must state to what extent the losses of subsidiary companies have been taken into account in arriving at the profits and losses of the holding company as disclosed in its accounts

It is important to note, however, that it is not necessary to specify in this statement the actual amount of the profits or losses of any subsidiary company or the actual amount of any part of any such profits or losses which has been dealt with in any particular manner

The wording of this Section of the Act, as an example of lucidity and draughtsmanship, leaves, to say the least, something to be desired, in addition to which, in the opinion of the writer, it is ineffective in attaining the underlying objective

In a brilliant paper on holding companies delivered before the International Congress on Accounting in 1933[1] when dealing with the terms of this section, the late Sir Albert Wyon stated "I venture to think that the particulars required by the Act to be disclosed are of so general and vague a character as to be quite insufficient to supply shareholders with the information necessary for them, if they are to have a just view of the earnings of the enterprise in which they are interested and of its prospects The provisions which I have epitomized may indeed have the unintended effect of providing justification for directors who wish so to prepare the accounts of a holding company as to conceal from those chiefly interested the actual results of its activities "

The writer entirely agrees with these views of the late Sir Albert Wyon, and will endeavour to explain why, in his opinion, the terms of the Act fall short of the real solution of this important problem

The Value and Importance of a Consolidated Earnings Statement

Although the members of the holding company are shareholders of that company only, they are directly interested in the fortunes of the whole group Therefore, in order to obtain a clear view as to the state of their investment in the parent company, it seems reasonable to suggest that they should be enabled from year to year to learn something of the character, the financial health and the earning capacity of the parents *and* all the children

The true test of the value of any commercial enterprise is its capacity to earn profits A clear picture, therefore, of the earnings of the whole group of companies is the only means by which the members of a holding company can judge as to the success or failure of the combine in which they are interested

The writer would like to emphasize this point strongly, as in his view it is the key to the whole problem

There has developed a strong demand for the production

[1] 'Holding and Subsidiary Companies—Accounting Principles involved in the Treatment of Earnings and Valuation of Holdings' published in *The Accountant* of 5th August 1933

of so-called "consolidated Balance Sheets," which are of great assistance, but in the writer's opinion a consolidated earnings statement is of even greater value and importance.

As the law stands, however, it is not compulsory for a holding company to present to its shareholders any view of the earnings of the combine as a whole. In fact the board of a holding company, acting strictly within the terms of the Companies Act, can present a Profit and Loss Account which gives no indication whatever as to the true earnings of the group as a whole. For under the Act, all that the directors of a holding company are bound to do each year is to lay before the company in general meeting the Profit and Loss Account of the holding company itself.

In drawing up this Profit and Loss Account the board could take credit for the dividends declared or to be declared by the profitable subsidiaries and make no provision for the holding company's proportion of the losses of the unprofitable ones. If such losses were substantial in amount a most incomplete view of the earnings of the combine would be given to the shareholders and although, in the statement annexed to the Balance Sheet, the directors would be bound to state the fact that such losses had not been provided for, they would not have to disclose the amount of the aggregate losses.

The reader may ask "What about the company's auditor?" But what can he do except qualify his report to the effect that in his opinion the value of the investments in subsidiaries is overstated in the Balance Sheet by reason of the fact that provision had not been made for the losses of subsidiary companies. Such a statement would be a warning, but it would give no indication as to the amounts involved and therefore the shareholders would still be completely in the dark as to the true position of affairs.

In recent years a strong public demand has developed for the publication of Consolidated Statements, as is evidenced by the fact that the shareholders of the Gaumont British Company adjourned the annual general meeting until such time as a Consolidated Statement was produced. (See *The Accountant*, Vol. XCV, page 643.)

The Treatment of Abnormal Items Taken to Credit

Furthermore, it is possible for the directors to declare as dividend only a proportion of the available profits of subsidiaries Such undistributed profits would therefore in effect form a secret reserve, as to the existence of which the shareholders of the holding company would not necessarily have any indication

If in a subsequent year the profits of the combine fell, it would be possible for the subsidiaries to declare dividends out of the undistributed profits accumulated in past years Such dividends could be properly taken to credit by the holding company, as income of the year in respect of which they had been declared There is nothing in the Act making it compulsory for this fact to be made clear and if it were not, then the results shown by the holding company's accounts would give a distorted view of the earnings of the combine for that year There is nothing wrong in the declaration of dividends out of profits accumulated in the past, but dividends paid out of past profits of subsidiaries and received by a holding company represent, in effect, the drawing upon reserves created in the past

The writer is strongly of opinion that in the case of all companies it is of the utmost importance that abnormal items taken to credit should be separately stated and clearly described in the Profit and Loss Account, as otherwise, if these items are material in amount, shareholders will obtain an incorrect view of the normal earnings of the undertaking for the particular year in question The great importance of this factor was made abundantly clear in the *Royal Mail Steam Packet* case

Undistributed Profits of Subsidiaries at the Time of Acquisition of Shares

At the time that the shares in a subsidiary are acquired by the holding company there may be in existence undistributed profits in the accounts of that subsidiary

If in a subsequent year the whole or part of such undistributed profits is distributed as dividend, then in the hands of the holding company such dividend represents capital, and not income

In arriving at the sum paid for the shares, the undistributed profits will have been taken into account, and such undistributed profits will therefore be included in the purchase price. In these circumstances, on receipt of the dividend from the subsidiary by the holding company, the proportion (if any) representing profits which were undistributed at the time of acquisition of the shares should be deducted from the cost of the investment, thus reducing its value in the holding company's Balance Sheet.

Inter-company Transactions

Inevitably in the case of combines there are inter-company transactions, and for example company A may sell goods to company B. If at the date of the Balance Sheet company B has part of these goods in stock, they will be valued in the ordinary way at cost, if the realizable value has been maintained. This cost price will include the profit on the sale charged by company A.

Companies A and B are separate legal entities and notwithstanding the legal position that A could sue B for the price charged, the fact remains that, from the point of view of the group as a whole, such a sale is a mere inter-company transaction, therefore unless and until the goods in question are sold to customers outside the group, no true profit can be said to have arisen.

A similar point arises if one company does work of a capital nature for another within the group, such as a sale of plant. The selling company may properly charge a price that includes a reasonable profit and the purchasing company will capitalize this item at the invoice price. In the accounts of the holding company credit should not be taken for this profit which lies in the accounts of the supplying company, as this again merely represents in effect an internal or inter-company adjustment.

A debatable point arises as to the set of accounts in which the adjustment for inter-company profits should be made. In the writer's view, this provision should be made in the books of the holding company, as in the case of subsidiaries the position may be complicated by reason of the existence of minority interests.

The foregoing is a description of the general situation

as regards earnings and the principal points arising in connexion therewith The problem is as to how best to obtain a clear view, firstly, of the earnings of the holding company itself and secondly of the earnings of the group as a whole This is a complex and difficult question, the solution of which all are earnestly trying to find This matter will be referred to in some detail later

The Balance Sheet Position

Turning now to the Balance Sheet position, here again it must be remembered that each company within the group is a separate legal entity and each one including the holding company has to prepare its own Balance Sheet, and these individual Balance Sheets only are of direct interest to the creditors of the respective companies

As regards the form of presentation of the Balance Sheets of the subsidiaries, here again there are no special points to deal with, but very important questions arise in connexion with the Balance Sheet of the holding company

In addition to being a majority shareholder in the subsidiary companies, the holding company not infrequently acts as the banker for the group and provides the subsidiaries with any necessary finance in the form of loans and/or advances on fixed and/or current account On the other hand, surplus funds of subsidiaries are often deposited with the holding company

In this way a considerable proportion, in some cases practically the whole, of the capital of the holding company may be represented by investments in and advances to subsidiary companies

In the case of a pure holding company, i e one that itself does not carry on any trading activities, it is common to find that practically the whole of the assets of the holding company are represented by investments in and advances to subsidiary and associated companies

The Legal Balance Sheet and Its Limitations

Under the Companies Act, all that a holding company is bound to submit to its shareholders is its legal Balance Sheet in which the aggregate of the investments in, the advances to and the advances from subsidiary

companies, must be stated separately, in addition to which the basis of valuation of these investments which are fixed assets must be stated

Such a Balance Sheet gives no indication (*a*) as to the financial position of the combine as a whole, (*b*) as to the financial position of the subsidiary companies as a group, (*c*) whether the investment in subsidiary companies is represented by, e g, 99 per cent net tangible assets and 1 per cent goodwill or vice versa, (*d*) what proportion of the assets of the subsidiary companies is represented by fixed and what proportion by current assets, (*e*) what are the liabilities of and (*f*) what are the reserves of the subsidiary companies

Without this information it is obviously impossible to form any idea as to the financial position of the combine as a whole For example it is possible for the Balance Sheet of the holding company to show a strong liquid position, although many of the subsidiaries may be in a hopelessly insolvent condition This has been the position revealed in the case of many of the spectacular failures in the past

Taken by itself, the legal Balance Sheet of a holding company cannot possibly give a clear view of the financial position of the group of companies as a whole It is for this reason that there has developed an ever-increasing demand for fuller and more detailed information In this connexion Lord Plender stated, "having regard to the extent to which business is carried on through the medium of subsidiary companies, in my opinion the time has come when the whole question of further and more adequate disclosure should be reviewed" At the fifth International Congress on Accounting, Mr Chas J G Palmour, F C A, stated "It appears to be universally agreed that the normal or legal form of Balance Sheet does not convey sufficient information to the shareholders of a holding company and that some form of consolidated financial statement should also be issued" (See *The Accountant,* Vol XCIX, page 495) With these opinions probably all are in entire accord, it rests therefore with those responsible for the administration of holding companies, in co-operation with accountants, to concentrate upon finding the solution of this difficult problem

The Need for a Clear View of (a) the Earnings, and (b) the Financial Position of the Whole Group of Companies

Obviously, as is the case with every undertaking, in order to obtain a clear view of the financial position and progress of a holding company it is necessary to see on the one hand the earnings and on the other hand the financial position of the whole group of companies. If this information is available it is possible to judge whether the aggregate earnings represent a reasonable return upon the total capital invested in the group, and to follow the trend of this relationship from year to year. This, it seems to the writer, is the paramount factor and the crux of the whole problem, the solution of which, it is suggested, lies in the direction firstly of the preparation of a consolidated statement of earnings and secondly of a consolidated statement of the assets and liabilities either of the whole group of companies or of the subsidiary and sub-subsidiary companies as a group. In the latter case this statement will show exactly what is comprised in the items appearing in the holding company's Balance Sheet, i.e. investments in and advances to and from subsidiary companies.

A further alternative, which, in the writer's opinion, has much to recommend it, is to prepare a consolidated statement of assets and liabilities of the subsidiaries and also a consolidated statement embracing the Balance Sheets of the subsidiary and sub-subsidiary companies and the Balance Sheet of the holding company. In this way the financial position can be seen from three important viewpoints. Firstly, the position of the holding company would be shown by its legal Balance Sheet, including the total investment in subsidiaries. Secondly, that which lies behind the investment in the subsidiaries would be revealed by the consolidated statement of the assets and liabilities of the subsidiaries. Thirdly, the consolidation of the latter statement with the legal Balance Sheet of the holding company would reveal the overall financial position of the entire group of companies.

In the case of all of these consolidated statements,

as regards both earnings and assets and liabilities, it is important to appreciate that they are statistical statements only, prepared for the benefit of the shareholders of the holding company. These statements are built up from the Profit and Loss Accounts and Balance Sheets of all of the companies within the group, and they are not therefore the accounts of one business undertaking.

In preparing these statements also it must be borne in mind that adjustments have to be made in the case of all of these consolidated statements for the interest of outside shareholders. The holding company is entitled to a proportion only of the aggregate earnings and of the surplus of assets over liabilities of the subsidiaries. That proportion is governed by the holding company's share of the equity of the respective companies.

In addition, of course, all items representing inter-company indebtedness should cancel out. In those cases in which the financial years of the parent and subsidiaries do not coincide an adjustment has, of course, to be made.

The Dunlop Rubber Co.'s Report and Accounts

In order to illustrate a method of presentation of the accounts of a holding company international in character, and with a view to illustrating the main points under consideration, the reader is referred to the Dunlop Rubber Co.'s report and accounts appearing in Appendix A. This appendix also includes the reports and accounts of Dunlop Cotton Mills Ltd. and Dunlop Plantations Ltd.

In the first place it is desired to make a few remarks upon the broad basis of the report and accounts.

It will be observed that the directors' report is much fuller and more informative than is usual in this country. In the case of the profit figures and also the Balance Sheet position, comparisons with the figures for the previous year are given with explanations as to the principal variations. It will be observed also that in addition on pages 306 to 307 comparative results for five years are given, so that the main financial trends may be clearly seen. In this way the Board endeavours to read the accounts for the benefit of the shareholders, and to give a general report on the year's operations.

This procedure has a practical advantage as it relieves the chairman's speech at the annual meeting of a considerable burden of detail figures and leaves him free to deal with the major matters and questions of general policy

All will have seen many directors' reports that contain merely a statement as to the profits available and the recommended appropriations together with the names of the directors due to retire by rotation and that they and the auditors offer themselves for re-appointment It always seems to the writer that a board should have more than this to say in its annual report to the shareholders There is no question that the directors' report can most helpfully be used to amplify and clarify for the benefit of the shareholders and others the information contained in the accounts themselves and that the development of this practice is worthy of the consideration of the boards of public companies

Turning to the Balance Sheet, it will be observed that the items are grouped and that sub-totals are given This simple innovation greatly facilitates the reading of a Balance Sheet For example, the ratio of current liabilities to current assets and other important ratios can be seen at a glance The grouping in this way of items in a Balance Sheet seems to the writer to be so obviously helpful that he is surprised to see so many Balance Sheets still published in the old conventional manner

It will be observed also that the figures for the preceding year are given, which enables the variations to be readily seen The inclusion of the figures for the preceding year is a practice that is much appreciated both by shareholders and by the financial press, as it greatly facilitates the reading of the accounts

It will also have been noticed that the figures are shown to the nearest £ This is done merely with a view to making the statements easier to read It will be appreciated that the actual accounts on the company's files contain the shillings and pence, and that it is merely when printing these documents for publication that this company is so bold and unorthodox as to delete the shillings and pence

The Inclusion of Proposed Dividends Less Income Tax

It will be observed that under the heading of Current Liabilities and Provisions, in the Balance Sheet, and also in the Profit and Loss Account, there are included the proposed dividends and also all dividends are shown in the accounts after deduction of Income Tax

In the year 1929, as auditor of a public company, the writer persuaded the Board of that company[1] to include in its accounts the proposed dividends and also to show the dividends less income tax, although this form of presentation was unorthodox and contrary to all teaching and the then accounting practice In fact to-day, so far as the writer is aware, there is not a textbook that supports this method, except this one Since 1929, however, an ever-increasing number of the leading companies in this country have adopted this method of presentation

It is interesting to note that the inclusion of proposed dividends is a common and long established practice in the banking world, the Commercial Bank of Scotland having presented its accounts in this form since the year 1879 This actual Balance Sheet appears in *The Accountant*, Vol XCVI, page 398

In view of the difference of opinion that exists as regards this not unimportant point, it may be of interest to attempt to summarize the arguments in favour of this modern form of presentation

As regards the deduction of income tax from dividends, the income tax liability of a company is computed upon the basis of the company's earnings and is in no way affected by its dividend distributions The income tax deducted from dividends does not have to be accounted for to the Inland Revenue as is the case with loan interest and other such annual payments

A distribution of profits by a company is taxed income in the hands of members and therefore, of course, has to be included in the individual member's income tax return at the gross amount Therefore, to declare a dividend less income tax is convenient, as it makes clear to members the

[1] The accounts of this company were reviewed in *The Accountant* Vol LXXXI, page 593

exact amount to be included in their income tax returns But from the company's point of view it is only the net amount of the dividend, i e the cash distribution, that affects its financial position For example, a dividend of 8 per cent less income tax at 5s is exactly the same as one of 6 per cent tax free both as regards the company and each member, but under the orthodox method of presentation the carry-forward shown in the directors' report would be greater in the case of the tax free declaration The writer finds it difficult to understand why this should be so

Under the orthodox method a declaration less tax has the effect of crediting the succeeding year's revenue account with an amount representing the income tax deducted from the dividend paid in respect of the preceding year's profits

It is submitted that the modern method is far more simple and also, it is suggested, correct

Before arriving at a company's net profit available for distribution there has to be taken into account not only the reserves which the directors in the exercise of their discretion deem it expedient to set aside, but also the provision for income tax, which cannot be less than, but may well exceed, the amount of the company's statutory liability That which remains for distribution therefore is in truth and in fact a taxed, or what might be termed a "Net," Fund It seems to the writer but elementary logic that that which is paid out of that fund by way of dividend from which tax is deducted should likewise be expressed as a net sum

As regards the embodying of the proposed dividend in the accounts, it is, of course, true that the directors' recommendation as to dividend is subject to the approval of the members in general meeting, but it is of importance to note that the members are powerless to *increase* the amount recommended by the Board They may, on the other hand, reduce the proposed dividend, but in forty years' experience the writer can recall no instance in which this has occurred The risk of such an eventuality is so remote that it appears to the writer to be a singularly impotent weapon with which to attack the advocates of the modern method of presentation

Moreover, the appropriations arise directly out of the

operations of the past year, but the orthodox method cuts across the accounts for two years as last year's appropriations have to be included in the succeeding year's Appropriation Account

In reading a Balance Sheet two vital factors which it is essential one should see clearly are (*a*) What exactly is the amount of the members' interest in the company, i e the share capital plus reserves and undivided profits, and (*b*) what exactly is the amount of the working capital, i e the surplus of the current assets over the current liabilities

In the case of the orthodox Balance Sheet it is usually necessary to take pencil and paper and work out these two figures, as the proposed dividend distribution has to be deducted from the total of the members' interest as disclosed in the Balance Sheet, in addition to which it affects the surplus of current assets over current liabilities But why, it is asked, should those reading a Balance Sheet have to make such adjustments in order to arrive at the true state of affairs? The modern method has at least the merit that the real picture is presented in such a way that "he who runs may read"

Personally the writer cannot understand how it can be said to be wrong to provide in the Appropriation Account and in the Balance Sheet for a proposed dividend so long as it is so designated, as the dividend arises directly out of the past year's operations, although it is admitted that it does not become a legal liability until it is voted by the members Further, the dividend distribution is without doubt a known contingency, the amount of which is to all intents and purposes known exactly It has always been accepted practice to provide for known contingencies such as, for example, a claim in respect of which litigation is pending In this case it is not known whether an actual liability will materialize, what will be the amount, and the date when the payment will have to be made

In such circumstances no one, it is suggested, would contend that it would be wrong for a Board to make a reserve for this possible liability which might in fact never materialize, and in spite of the fact that the amount of the provision would be a matter of pure guess-work Why, therefore, can it be wrong to provide for a dividend

distribution which is a known contingency (*a*) directly arising out of the operations for the past year, (*b*) which for practical purposes is certain to materialize, and (*c*) the amount of which for practical purposes is exactly known? Of all the many contingencies that have to be provided for in the preparation of Balance Sheets, it is submitted that there is none so certain to materialize as the dividends recommended by a Board of Directors

In accordance with modern practice, the dividend recommendation is shown in the Appropriation Account and also in the Balance Sheet as "Proposed Dividend less Income Tax" It is submitted, therefore, that in this way it is made quite clear that the dividend is not included as representing a legal liability at the date of the Balance Sheet, but as a reservation for a known contingency In these circumstances the writer cannot see how it can be argued that this form of presentation of the accounts of a company is wrong

It may be contended that the members may not accept the dividend recommendation of the directors This is true in theory, but very unlikely in practice If this did occur, then the accounts as submitted would have to be amended, which has always been a possibility, as the Balance Sheet itself is submitted at the Annual General Meeting for the approval of the members, who have the power to refuse to adopt the accounts as presented by the directors Recently the members of a well-known company refused to pass the Balance Sheet as submitted by the Board

Under the modern method the Board submits to the members accounts which embrace the recommended appropriations, both the accounts and the dividend recommendations being, of course, subject to the approval of the members The great advantages of this method are that in this way the members are enabled to see at a glance the exact effect that the Board's recommendations will have upon the company's financial position

Furthermore, it is submitted that from the practical point of view the inclusion of the proposed dividends less income tax makes accounts much simpler in form and easier to read That this form of presentation is appreciated by

the public is evidenced by the widespread and enthusiastic reception it has received in the Press and by the general public, and, furthermore, by the fact that an ever-increasing number of companies are adopting this method of presentation

Ten years of practical experience have strengthened and confirmed the writer's original thoughts on the subject and he is convinced that this form of presentation is a great improvement on the orthodox one After all, every custom began as a broken precedent, and the writer is no longer content to burn incense at the altar of accounting convention when logic, common sense, and practical expediency make irresistible demands that that convention should be superseded

The orthodox views upon this subject are ably reviewed by Mr Bertram Nelson in an article which appears in the issue of *Accountancy* of the 1st October, 1938 Mr Nelson's article was in reply to one written by the author, and upon which the foregoing views are based

It is now proposed to consider each of the statements in the accounts shown in Appendix A with a view to illustrating a form of presentation which is in some directions a departure from general practice

Statement of Profits (*page 299*)

In the writer's opinion this statement represents the most interesting feature of these accounts and answers some of the most vexed questions that arise in connexion with the accounts of holding companies

It will be observed that "*Item I*" represents the aggregate profits for the year of the parent company, including its proportion of the profits less losses of all subsidiary and sub-subsidiary companies, but before providing for payments in respect of guaranteed preference dividends and British and foreign taxation

This figure therefore represents the normal earnings of the whole group of companies for the year, after adjustment for minority interests The total profits thus shown can, therefore, be related to the total capital employed in the whole combine as shown by the consolidated statement of assets and liabilities (pages 304 and 305) and thus

on the one hand the earnings can be judged and on the other hand the reasonableness or otherwise of the figures at which the combined assets stand

"*Item II*" is of special interest It will be observed that it represents the main company's proportion of items which do not represent normal earnings attributable to the current year In a large group of companies there are from time to time inevitably "windfalls," but under this form of presentation such items are clearly separated from the normal earnings Further, if subsidiary companies were to declare dividends out of past profits, such dividends would come under this heading as representing abnormal items In this way, therefore, if past reserves are drawn upon or credit is taken for any other abnormal items, this fact and the aggregate amount involved is clearly stated

It will be observed that the statement then gives particulars (*Item IV* (*a*)-(*d*)) of the amounts deducted from the earnings of subsidiary and sub-subsidiary companies in respect of British and foreign taxation and guaranteed preference dividends

Item IV (*e*) is another item of special interest as it shows the total amount of the profits of subsidiaries held back during the year by those companies by way of special appropriations and undistributed profits held in reserve If, therefore, undistributed profits were accumulated in the hands of subsidiaries this fact and the aggregate amount involved is clearly stated

Item V represents the balance of profits available to the parent company and agrees with its Profit and Loss Account (pages 302 and 303) The remainder of this statement does not call for special comment

This statement, it will be agreed, is a very simple one, but it does, it is suggested, give a clear view of the aggregate earnings of the combine as a whole and of the holding company itself Further, it clearly separates normal and abnormal earnings and shows the amount of undistributed profits of subsidiaries and special appropriations that are being retained by those companies It will be observed also that this statement embraces sub-subsidiary companies to which, by a curious omission, the Companies Act does not refer and although the law apparently takes no cognizance of grand-

children from grandfather's point of view, anything in the nature of a portrait of the family group cannot reasonably exclude these not infrequently numerous descendants

Profit and Loss Account (*pages 302 and 303*)

There are no special features in connexion with the Profit and Loss Account of the holding company itself, except that here again abnormal items are shown separately and as already stated the proposed dividends are included

It is suggested that this form of presentation of the earnings in the two statements considered above does answer the various points of difficulty in connexion with holding companies that have already been described In any event, it does represent an honest attempt to solve those problems

Balance Sheet of the Holding Company (*pages 300 and 301*)

As regards the Balance Sheet of the holding company itself, the main features have already been dealt with, but there are just two points to which reference should be made

Amongst the reserves (*Item II* (*e*)) an item appears "reserve for inter-company profits in inventory valuations of subsidiary companies" As has been explained, in the case of a holding company, it is highly desirable to make adjustment for inter-company profits of this nature but the writer had never before seen the item separately and distinctly stated It is suggested that there is an advantage in doing this as it makes it clear that these adjustments have in fact been made

It will also be noted that the reserve for contingencies (*Item II* (*c*)) is separately stated It is not uncommon in published Balance Sheets for an item of this character to be merged with sundry creditors, but the writer is of the opinion that, with the possible exception of banks, which are in a category by themselves, it is wiser to disclose all items of this nature

Consolidated Statement of Assets and Liabilities (*pages 304 and 305*)

By way of preface to the remarks under this heading the writer would like to take this opportunity of expressing the

opinion that the term "consolidated Balance Sheet" which is so frequently used is a misnomer There can, in his view, strictly speaking, be no such thing

The term "Balance Sheet" implies a picture of the financial position of *a* company—*a* firm, *an* individual, *an* institution—in other words a self-contained unit or entity—and the moment one travels beyond the limits of that unit and seeks to conglomerate a series of such pictures the result can never be a Balance Sheet, but is nothing more than a consolidated statement of assets and liabilities which it will be observed is the title under which the Dunlop Co has presented the picture of its family group

The first feature to which attention should be directed is the indication which is clearly given at the head of the statement as to the exact point at which consolidation has been effected, i e that the statement embraces all subsidiary and sub-subsidiary companies in which over 50 per cent of the ordinary shares or stock and over 50 per cent of the voting control is held within the group

The exact point of consolidation is an interesting and debatable question Some holding companies take the view that a 75 per cent holding should be the determining point, presumably on the ground that such a majority is necessary in order to gain effective control having regard to the voting majority requisite for the passing of a special resolution

It is not proposed to discuss this question, but merely to point out that it is not common practice to indicate on such statements the precise point at which consolidation has been adopted

For reasons that are given in the Directors' Report, it will be observed that the assets and liabilities of the German companies have not been classified under their respective headings in the Consolidated Statement of Assets and Liabilities As regards the treatment of the profits made in Germany, the reader is referred to the note appearing at the foot of the Statement of Comparative Results appearing upon page 306 An interesting question of principle is involved, namely, as to whether it is correct to consolidate profits and assets and liabilities of a subsidiary company in a foreign country when, owing to

exchange restrictions, it is impossible to remit dividends or surplus funds out of that country

Although the holding company may own 100 per cent of the shares in the foreign subsidiary, yet it is obvious that under these exceptional circumstances the holding company is not in a position to exercise effective control

If it were decided to consolidate, the difficult problem would immediately arise as to the basis upon which the German profits and assets and liabilities should be valued, i e what rate of exchange should be adopted It will be seen that in these circumstances the Directors of the Dunlop Rubber Company decided not to consolidate the German assets and liabilities, and to show the parent company's investments in the German companies as a separate item (*Item II (d)*) under the heading of Investments in the Consolidated Statement of Assets and Liabilities The investments in the German subsidiaries are, therefore, treated in exactly the same way as investments in Associated companies which latter, as has been stated, represent companies which the holding company does not control As regards the profits made in Germany, it will be observed from the footnote on page 306 that these are only included to the extent of dividends actually received by the parent company

The statement which shows the financial position of the group of companies as a whole follows substantially, so far as arrangement and grouping of items is concerned, the same lines as the legal Balance Sheet

The object of this statement is to reveal what lies behind that large "umbrella" which the legal Balance Sheet shows "father" holding in his hand in the shape of investments in and advances to and from subsidiary companies, and, read in conjunction with the statement of profits which reveals the aggregate earnings of the group as a whole, presents, it is submitted, a complete picture Thus shareholders are enabled to obtain a reasonably clear view, both of the earnings and of the financial position of the group of companies in which through their shares in the parent company they are interested as investors

This statement is, of course, made up from the Balance Sheets of all of the companies within the group, in

accordance with the definition at the head of the statement to which reference has been made

The interest of outside shareholders, it will be seen, is separately stated on the left-hand side (*Item III*) In arriving at this figure there must be taken into account the outside shareholders' proportion of general reserves and undistributed profits or losses

On the other side of the Balance Sheet the item "Goodwill Accounts" (*Item IV*) may puzzle some readers Upon consolidation there may, of course, be items of goodwill in some of the various Balance Sheets In addition, when purchasing shares in subsidiary companies the holding company may have paid more or less than the par value for the shares, and in consequence adjustments in respect of these differences become necessary

For example, suppose a case where a holding company purchased for a sum of £200,000 the whole of the issued share capital of another company consisting of 150,000 shares of £1 each It happens that the Balance Sheet of the latter company discloses the following position—

	£		£
Share Capital	150 000	Goodwill	10,000
Creditors	130,000	Tangible Assets	290,000
Profit and Loss Account	20,000		
	£300 000		£300 000

Assume further that the purchase was effected on the day on which the holding company closed its accounts and that the newly acquired subsidiary's Balance Sheet is therefore coming into the consolidated statement to be prepared

In the first place there is the asset of £200,000 (the cost of the shares) appearing in the legal Balance Sheet which is expunged from the consolidated statement in order that its place may be taken in the latter document by that which the investment represents, namely the assets less the liabilities of the subsidiary company

There therefore comes into the consolidated statement the various tangible assets of the subsidiary, which will be grouped under their appropriate headings

	totalling	£290 000
There will also come in under the heading of goodwill the amount at which that asset stands in the subsidiary Balance Sheet viz	£10 000	
The holding company had to pay a premium for these shares which is not represented by any specific asset in the subsidiary s accounts	50 000	
Thus for the consolidated statement a goodwill figure appears of	60 000	
Although however the holding company paid this premium for the shares there were undistributed profits in the subsidiary which the holding company can abstract by way of dividend at once if it will so that these profits should properly be deducted	20 000	
Leaving as the effective price paid for the goodwill of the subsidiary		40,000
The total accounted for on the assets side of the consolidated statement is thus		330 000
After inserting on the liabilities side of the statement the subsidiary company s creditors amounting to		130 000
There is left a difference of		£200 000

which it will be observed is exactly equal to the cost of the investment appearing in the legal Balance Sheet

Comparative Results *(pages 306 to 307)*

It will be observed that the comparative results give in the first place particulars for the five years 1933 to 1937 of the aggregate profits of the Dunlop Rubber Co and all of its subsidiary and sub-subsidiary companies and, after deducting therefrom the Dunlop Rubber Company's proportion of British and foreign taxation and guaranteed preference dividends borne by the subsidiaries, the balance of profit available to the Dunlop Rubber Company

The next statement shows how the annual profits available each year to the Dunlop Rubber Company were appropriated

Particulars are then given of the total issued share and loan capital of the Dunlop Rubber Co and also particulars of the surplus and reserves

The final statement shows the surplus of current assets over current liabilities, firstly of the Dunlop Rubber Co and, secondly, on the consolidated position

The object of these statements is to enable shareholders to obtain a clear view of the main financial trends and thus to make the accounts as informative as possible

Conclusions

In the case of a large international holding company the form of presentation of the accounts is a complex problem It has first to be decided exactly what information should be given and then how it can best be presented The aim should be to give the shareholders all the information that they may reasonably expect in as clear and simple a form as is possible

The argument is commonly put forward that it may be very hurtful to a holding company to publish consolidated statements of earnings and of assets and liabilities, on the ground that this information may be used by competitors to the detriment of the combine

The writer finds great difficulty in accepting this argument, in fact, upon the lines described, he cannot imagine how the information disclosed can be utilized by competitors to the detriment of a holding company

It is often stated that such disclosures may be harmless in good times but that a holding company would regret such disclosure when bad times came The writer does not agree The directors of a company cannot always prevent a fall in profits or even losses If in such circumstances the earnings of the combine suffer, surely the shareholders are entitled to see the real effect of the adverse trading conditions upon the company Experience clearly shows that directors have got into serious difficulties only when they framed their accounts so as to withhold from the shareholders a true view of the position of affairs

The writer ventures the opinion that no holding company that has issued consolidated statements would testify that the company had suffered thereby in any way Experience, it is suggested, is all the other way, in that the publication of informative accounts tends to breed that confidence of shareholders and of the public generally which is of real commercial value to any undertaking

The presentation of accounts with the obvious intention of withholding information is frequently the forerunner of rumour and ill-founded conjecture which competitors may exploit to the detriment of a company

The writer's own view is that both from the ethical and the

commercial standpoint, full and informative accounts are, in the long run, the only wise policy

There is no question that in the case of holding companies there has developed a strong public demand calling for more informative accounts, and to illustrate the public response to the issuing of consolidated statements the following are three extracts from the Press referring to the accounts of the Dunlop Rubber Company for 1933, when this form of presentation was first introduced

The Accountant—It is almost impossible to find sufficient praise with which to acclaim the new standard in company accounting set up by the 1933 accounts of the Dunlop Rubber Co Ltd Our best commendation is really their appearance in this week s issue of *The Accountant* so that the accountancy profession itself may see the high level of informativeness that is possible in company accounts particularly in the case of holding companies, if the determination of the management and officials is directed towards that end These accounts answer all the present-day criticism regarding the obscurity that is possible in the earnings and assets of subsidiary companies when accounts are presented in the manner allowed by law Especially do they cover those points such as the holding up of profits in the accounts of subsidiaries and the accumulation of secret reserves and the subsequent declaration of dividends by subsidiaries wholly or partly out of profits of previous years

The Daily Telegraph—The 1933 accounts of the Dunlop Rubber Co will be a joy to its own shareholders and the envy of all others Detailed balance sheets, classification according to liquidity, comparative figures, and even ' consolidated" statements are now, happily, familiar features of many accounts, though in all these improvements Dunlop has led the way But no other company has yet had the courage so far to break with tradition as to give what may be called a "consolidated" profit and loss account, revealing the precise treatment of all subsidiary earnings and segregating all special credits, or to state plainly that all reserves are now disclosed All these details now appear, and in the most unambiguous terms, with comparative figures in each case The shareholder can hardly ask for more It is no doubt too much to hope that all holding companies will speedily follow the Dunlop example, but, now that tradition has once been broken, it is probable that really frank inter-company statements will become more and more common If so, Dunlop will earn the lasting gratitude of all discerning investors

The Economist—The report of the Dunlop Rubber Co for 1933 places the company in the forefront of British concerns as regards the publication of clear, detailed and comprehensive accounts The document embodies nearly all that *The Economist* and other critics of obscurantism have advocated, in season and out of season, for years past, and gives the lie to the familiar assertion that a large holding company cannot afford to go beyond the meagre disclosure laid down by law, for fear of giving away valuable information to its competitors

These and similar comments in the Press in many parts of the world have encouraged the writer to feel that

this company is upon the right course and, further, he is of the belief that through the new form of presentation of its accounts the Dunlop Company has lost nothing, but gained much.

There are those who argue that a holding company should disclose the names, the accounts, and the amount of the holding company's investment in each subsidiary and sub-subsidiary company. There are holding companies that disclose this information and some contend that this practice should be made compulsory by law. The writer is firmly of the opinion that this suggestion is impracticable and undesirable as there are holding companies with many hundreds of subsidiaries. Furthermore, it is not uncommon for holding companies to acquire control of subsidiaries under circumstances where, in order to maintain the goodwill of the subsidiary, it is essential that it shall not be known to the public that the holding company is interested in the subsidiary.

Were this information disclosed, the demand would inevitably follow for particulars of trading results of individual subsidiaries. In cases where the number of subsidiaries is very numerous, this would be impracticable and, furthermore, most misleading conclusions might be drawn unless in many cases the trading basis between the various companies was also explained.

In the writer's opinion, the shareholders of a holding company should be presented with a clear view of the earnings and financial position of the group of companies as a whole and this can be effected by means of consolidated statements, but it is submitted that, in the majority of cases, it is not reasonable or desirable to disclose the names and particulars as regards the earnings and financial position, etc., of each subsidiary and sub-subsidiary of the holding company.

CHAPTER XIV

THE AUDIT OF THE ACCOUNTS OF HOLDING COMPANIES

As has been explained in the preceding chapter, each company within the group is a separate legal entity and therefore auditors must be appointed to audit the accounts of each. In the case of a subsidiary or sub-subsidiary company, no special points arise, but there are several important factors which should be borne in mind in connexion with the audit of the accounts of the holding company itself.

Although it is not legally necessary, there are advantages in one firm of auditors acting for the whole of the companies within the group, as in this way the auditors will acquire an inside knowledge of the whole of the ramifications of the group and will, therefore, be in a better position to trace through all inter-company transactions. There have been cases where unscrupulous directors have been able to cover up improper manipulations which would have been impossible had one firm audited the accounts of all the companies within the group.

It is not, however, always possible to arrange for one firm to audit the whole of the accounts, especially in the case of a holding company with subsidiaries in many different countries. If the auditors of the holding company do not audit the accounts of all of the subsidiary and sub-subsidiary companies, then they should examine the audited accounts of each subsidiary and sub-subsidiary company, and in cases where these are submitted in an abridged form they should also have access to the detailed accounts. In addition, information and explanations from the directors and auditors of the subsidiaries should be obtained in connexion with any questions upon which the auditors of the holding company are not clear, or upon which they require further data.

In cases where the holding company issues consolidated statements of profits and assets and liabilities, if the auditors of the holding company are instructed to audit these statements it will be necessary for them to see that

the accounts of the subsidiaries are prepared upon, as nearly as possible, a uniform basis In this connexion, Mr Chas J G Palmour, F C A , stated, at the fifth International Congress on Accounting—

It is generally agreed that, if at all possible, all Balance Sheets to be consolidated should be made up to the same date It is also considered important that each company within the group should have, as far as possible, a similar system of accountancy, so that the annual accounts may be prepared in a comparable form Another important point made is that the same basis of valuation should be applied to the stock in each constituent company and that plant and other fixed assets should be carried in the respective Balance Sheets and depreciated or amortised on a common basis (*The Accountant*, Vol XCIX, page 496)

The Companies Act, 1929—Sections 125, 126 and 127

Sections 125, 126 and 127 of the Companies Act, 1929, deal specifically with holding companies These sections, which are of the utmost importance to auditors, are as follows—

125 Where any of the assets of a company consist of shares in, or amounts owing (whether on account of a loan or otherwise) from a subsidiary company or subsidiary companies, the aggregate amount of those assets, distinguishing shares and indebtedness, shall be set out in the Balance Sheet of the first-mentioned company separately from all its other assets, and where a company is indebted, whether on account of a loan or otherwise, to a subsidiary company or subsidiary companies, the aggregate amount of that indebtedness shall be set out in the Balance Sheet of that company separately from all its other liabilities

126 —(1) Where a company (in this section referred to as "the holding company") holds shares either directly or through a nominee in a subsidiary company or in two or more subsidiary companies, there shall be annexed to the Balance Sheet of the holding company a statement, signed by the persons by whom in pursuance of section one hundred and twenty-nine of this Act the Balance Sheet is signed, stating how the profits and losses of the subsidiary company, or, where there are two or more subsidiary companies, the aggregate profits and losses of those companies, have, so far as they concern the holding company, been dealt with in, or for the purposes of, the accounts of the holding company, and in particular how, and to what extent—

(*a*) provision has been made for the losses of a subsidiary company either in the accounts of that company or of the holding company or of both, and
(*b*) losses of a subsidiary company have been taken into account by the directors of the holding company in arriving at the profits and losses of the holding company as disclosed in its accounts

Provided that it shall not be necessary to specify in any such statement

the actual amount of the profits or losses of any subsidiary company, or the actual amount of any part of any such profits or losses which has been dealt with in any particular manner

(2) If in the case of a subsidiary company the auditors' report on the Balance Sheet of the company does not state without qualification that the auditors have obtained all the information and explanations they have required and that the Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them and as shown by the books of the company the statement which is to be annexed as aforesaid to the Balance Sheet of the holding company shall contain particulars of the manner in which the report is qualified

(3) For the purposes of this section the profits or losses of a subsidiary company mean the profits or losses shown in any accounts of the subsidiary company made up to date within the period to which the accounts of the holding company relate, or, if there are no such accounts of the subsidiary company available at the time when the accounts of the holding company are made up, the profits or losses shown in the last previous accounts of the subsidiary company which became available within that period

(4) If for any reason the directors of the holding company are unable to obtain such information as is necessary for the preparation of the statement aforesaid, the directors who sign the Balance Sheet shall so report in writing and their report shall be annexed to the Balance Sheet in lieu of the statement

127—(1) Where the assets of a company consist in whole or in part of shares in another company, whether held directly or through a nominee and whether that other company is a company within the meaning of this Act or not, and—

(*a*) the amount of the shares so held is at the time when the accounts of the holding company are made up more than fifty per cent of the issued share capital of that other company or such as to entitle the company to more than fifty per cent of the voting power in that other company, or
(*b*) the company has power (not being power vested in it by virtue only of the provisions of a debenture trust deed or by virtue of shares issued to it for the purpose in pursuance of those provisions) directly or indirectly to appoint the majority of the directors of that other company,

that other company shall be deemed to be a subsidiary company within the meaning of this Act, and the expression 'subsidiary company" in this Act means a company in the case of which the conditions of this section are satisfied

(2) Where a company the ordinary business of which includes the lending of money holds shares in another company as security only, no account shall for the purpose of determining under this section whether that other company is a subsidiary company be taken of the shares so held

The main points arising in connexion with Section 125 have already been dealt with in the preceding chapter

Qualifications in the Reports of Auditors of Subsidiaries

Sub-section 2 of Section 126 lays upon the directors of a holding company an obligation to disclose particulars of the qualifications, if any, in the auditor's report on the accounts of a subsidiary company In complying with this requirement a difficulty is sometimes encountered in determining what precisely constitutes a qualification in regard to which disclosure is necessary

Although it is probable that opinions on the point may differ it is considered that a distinction can reasonably be drawn between what may broadly be classified as—

(*a*) Observations, and

(*b*) Reservations

contained in the auditor's report

Included in category (*a*) would be mere statements of fact which do not *per se* cast doubt or suspicion upon the figures in the Balance Sheet, for example—

> "The Stock in Trade has been ascertained and valued by the Company's Officials "
>
> "We have not examined the Title Deeds of the Properties, which are deposited with the Company's Bankers in Bombay "
>
> "Effect has been given in the Balance Sheet (31st December, 1932) to the terms of the Scheme of Capital Reorganization sanctioned by the High Court on the 19th January, 1933 "

It is felt, however, that Section 126 (2) is intended to embrace only those qualifications which properly fall under category (*b*), in which attention is directed, *inter alia*, to an overstatement in the value of an asset, the understatement of a liability, or the omission to indicate the existence of a contingent liability In brief, the question for determination appears to be whether the qualification is manifestly intended to convey to the members that the financial position of the company is or may be worse than the figures in the Balance Sheet indicate, and, if so, the position of the holding company is or may be affected to a corresponding extent

In this connexion it is of interest to observe in passing, the case where on the Balance Sheet of a subsidiary company a note appears indicating that the company is contingently liable for, say £30,000, for example, in respect of a claim

for damages which is in dispute. The fact of the note enables the auditor to give an unqualified report on the Subsidiary Balance Sheet. There are, therefore, no qualifications to be mentioned in the directors' statement on the holding company's Balance Sheet, nor is it obligatory upon them to disclose the fact that the subsidiary company has a contingent liability.

The auditor of the holding company, however, in considering the value of the holding company's investment in the subsidiary in question, would have regard to the fact of the contingency and in these circumstances he might consider that a qualification in his report on the Balance Sheet of the holding company was in consequence imperative, unless a note as to the contingent liability of the subsidiary was inserted on the holding company's Balance Sheet.

A peculiar position can arise where the auditor of the subsidiary company makes a specific qualification in his report relative to say the omission of a liability or the insufficiency of the amount of the depreciation charged. In this case, if the subsidiary is situated abroad, there may not be sufficient time in which to have amended accounts prepared and certified and sent to this country. Such a situation might be met by the holding company compensating for the defect by making a specific provision in its own accounts. In such circumstances although the qualification still remains in the report on the official Balance Sheet of the subsidiary company and should perhaps in the strictest legal sense be disclosed in the Directors' statement annexed to the holding company's Balance Sheet, it is felt that the omission so to do would expose the directors to little risk of criticism (the section imposes nothing in the shape of a penalty for its infraction) on the ground that the holding company has itself made good the shortcoming of its subsidiary, to which the latter's auditor has drawn attention through the qualification in his report.

Before leaving the subject it may be desirable to mention the case of subsidiaries in foreign countries, the laws of which do not call for any statutory form of audit report on the accounts of companies operating within their

jurisdiction In many such cases the local auditor may merely sign the Balance Sheet under a reference to the date of his detailed report thereon, which may be set out in the form of a letter devoted mainly to the submission of statistical information on the accounts Should the report be in this form it is none the less necessary to examine its terms with a view to ascertaining whether, interspersed in the detailed information, there is any statement which can reasonably be construed as a qualification falling under the category (*b*) i e Reservations, mentioned above, which comes within the ambit of the section

The Valuation of Investments in and Advances to Subsidiary and Sub-subsidiary Companies

The auditor of a holding company must satisfy himself that the investments in and advances to subsidiaries have been valued in the holding company's Balance Sheet in accordance with correct principles It is, therefore, of the utmost importance that these principles should be clearly defined, and the following is an attempt to do so

Subsidiary companies are financed by the parent company in various ways, e g by means of direct investment in the share capital of the subsidiary, by means of fixed or permanent loans to the subsidiary and/or by means of trade credits in the form of current accounts

As a matter of organization, it is most undesirable that permanent loans and current accounts should be combined in one account in the books of the respective companies

The fixed loan account is part of the holding company's permanent investment and, together with the share investment, represents the total permanent capital provided by the parent company By this means, the subsidiary is provided with the necessary fixed and working capital with which to carry on its trading operations

The current account, on the other hand, should embrace goods, charges, etc , together with loan interest and dividends due to the holding company The balances upon this account should be payable in cash upon a basis agreed between the two companies In the event of the working capital requirements of the subsidiary permanently increasing, the parent company may, from time to time, agree to

meet the situation partly or wholly by means of a transfer of an agreed amount from the current account to the fixed loan account

The accepted principle of valuation, as regards the share investments and the fixed loans, is cost less necessary reserves for the losses of subsidiaries The basis upon which the reserves for losses are calculated is discussed later

From the point of view of the holding company, investments in and permanent loans to subsidiaries are fixed assets and, therefore, the basis of valuation must be stated in the Balance Sheet In the Dunlop Rubber Company's Balance Sheet, given in Appendix "A," it will be seen that this item is described as "Investments and Advances at cost less amounts written off and reserves"

As these investments and advances are fixed assets held with a view to earning income, and not with a view to realization, the realizable value is properly disregarded Although there are exceptions to the rule, the normal test as to whether or not the holding company has made a sound investment in a subsidiary company is the ratio of the income yield upon such investment If consolidated statements are issued, the over-all position can be judged by comparing the consolidated earnings of the whole group of companies with the amount of the total capital invested in the group

In cases where a holding company has investments in and permanent advances to foreign subsidiaries, and these investments and advances are upon a currency basis, then for the same reasons it is not necessary to revalue these investments and advances from year to year, upon the basis of the rates of exchange on the date of the Balance Sheets In these circumstances, fluctuations in the exchange rates do not affect the capital position, except in the event of realization, but these exchange fluctuations will directly affect the amount of the annual income in the form of dividends and interest yielded by these investments and advances

In the case of true current accounts, the balances of which are payable by the subsidiary companies in cash, these, in fact, represent current assets to the holding company These balances, therefore, must be included in

the holding company's Balance Sheet at their realizable value, if that is lower than their book value If, therefore, such current accounts were upon a currency basis (i e the arrangement between the two companies being that the subsidiary is charged for goods supplied or services rendered, upon a currency basis) then, in making up the holding company's Balance Sheet, the whole of these debts would have to be valued upon the basis of the current exchange rates If, therefore, in the aggregate, upon revaluation in this way, the total value of these current accounts is below the total book value, then provision for this net difference should be made in the accounts of the holding company On the other hand, if the arrangements be that these current accounts are upon a sterling basis, then the exchange differences upon these current accounts would have to be provided for in the respective accounts of the subsidiaries

In the audit of the accounts of holding companies, the question of the valuation of the investments in, advances to, and current accounts with subsidiaries is the vital point of the audit The auditor must, therefore, satisfy himself that the methods adopted by the holding company are such that the Balance Sheet does give a reasonably clear view of the position If it does not, then he would be unwise if he failed to make the position clear by means of a qualification in his report

Further Points Arising in Connexion with Investments in Subsidiaries

The following are some further points to which the auditor of a holding company must direct his attention in considering the item of investments in subsidiary companies

If in the case of a subsidiary which declares a dividend wholly or partly out of profits which were earned prior to the date when the holding company acquired the shares in that subsidiary, that portion of the dividend which is paid out of such prior profits should, in the accounts of the holding company, be treated as a capital receipt, and not as revenue

The auditor must ascertain exactly how the profits and losses of subsidiary companies have been dealt with in the accounts of the holding company and of the subsidiaries, although there is no statutory obligation to disclose, in

the accounts of the holding company, the *amount* of such profits and losses In particular, he must ascertain whether or not the holding company has provided for the losses, or its appropriate proportion thereof, sustained by a subsidiary company or companies The effect of failure so to do is *prima facie* that no provision is made for what *may be* depreciation in the value of the holding company's investments in those companies

The words *prima facie* and *may be* are used advisedly, as this rule, although of general application, is by no means inflexible

To take a simple illustration of a holding company with one 100 per cent subsidiary only which was formed in 1929 Let it be assumed that the subsidiary has been consistently profitable, has paid regular dividends to the holding company, and that after payment of such dividends the subsidiary had a balance at the credit of its Profit and Loss Account brought forward at 31st December, 1935, of say £7000 The holding company has not taken this balance of undistributed profit into its accounts and the investment in the subsidiary stands in the holding company's books at the original cost of the capital subscribed, i e par If during the year 1936 a loss of say £3000 is sustained by the subsidiary, thereby reducing its carry forward to £4000, it would not be obligatory upon the holding company to provide for the loss of £3000 in its accounts, as no depreciation has taken place in the holding company's asset since acquisition, for the simple reason that the investment which stands in the holding company's books at cost is, notwithstanding the loss in 1936, worth £4000 more than its book value

From the point of view of financial policy, however, it is suggested that even in these circumstances it is advisable that this loss should be provided for in the accounts of the holding company, in order that a true view may be obtained of the earnings of the group of companies as a whole during the year under review This is particularly advisable in cases where a Consolidated Statement of Earnings is not published, as otherwise an incorrect view will be given of the earnings of the group for the particular year For example, in the foregoing illustration if the loss of the subsidiary

were not provided for, the profits of the holding company itself for 1936 would be shown without having regard to the loss of £3000 incurred during that year by the subsidiary

Again, where there are a number of subsidiary companies and some are profitable and others show losses, it is contended that the directors of the holding company are entitled to regard the group as a whole, and the necessity for providing for losses of the unfortunate members of the group may be removed if it is demonstrable that such losses in the aggregate are less than *the aggregate surplus and undistributed profits* for that year of the profitable subsidiaries Where, however, the point is reached that losses for a particular year in the aggregate exceed the aggregate undistributed profits for that year the necessity for making provision for the deficit in the holding company's accounts at once arises and failure so to provide will probably result in a qualification in the report of the auditor on the holding company's Balance Sheet, if the amount involved is material

In the case of a subsidiary which over a series of years has made heavy losses, it is possible that these losses in the aggregate may amount to more than the issued share capital of that subsidiary The finance of the subsidiary would then probably be provided by means of advances from the holding company In these circumstances, if for example a holding company had 75 per cent interest in the subsidiary, it should provide for 75 per cent of each year's losses until the whole of the share capital had been exhausted In subsequent years the holding company should provide for 100 per cent of the losses The outside shareholders cannot lose more than the whole of their share interest in the company When, therefore, the whole of their share capital and reserves have been lost the whole of the further losses are, in effect, encroaching on the holding company's advances

A debatable point arises in the case where the investment in the subsidiary company stands in the holding company's books at a premium and the subsidiary in question is sustaining losses If, for example, the investment appeared at a cost of £80,000 representing the whole of the share capital of the subsidiary which consists of 50,000 shares of £1 each, and the losses of the subsidiary eventually

aggregated £50,000, it follows that the whole of the capital in the subsidiary company has disappeared and if the holding company only provided for the trading losses on the footing of £ for £ it would be left with its investment in the subsidiary standing at £30,000 in its books whereas prima facie it is worthless

In such circumstances it is submitted that in the holding company's accounts there should be charged against each year's Profit and Loss Account any trading loss of the subsidiary As regards the premium of £30,000 paid for the shares, this in effect represents the amount paid for goodwill, and the sound policy in this case would be to write off the £30,000 by means of *appropriations* of profits or out of available reserves

Under the Act, as has been explained, it is not compulsory for the holding company to provide for its proportion of the losses of subsidiaries, but in these circumstances it is necessary under Section 126 for the directors to make it clear that these losses have not been provided for From an auditor's point of view a difficult situation arises if in the aggregate these losses are substantial in amount and have not been provided for, as obviously the shareholders of the holding company will not obtain from its accounts a clear view of the position of the group of companies in which they are interested

It is submitted that it is not the duty of the auditor in his report to disclose the aggregate amount of such losses, but that after careful consideration of the whole of the circumstances of the case, the auditor is entitled to and would be very unwise not to qualify his report to the effect that provision had not been made in the accounts of the holding company for its proportion of the losses incurred by certain subsidiary and/or sub-subsidiary companies

An important point arises in connexion with dividends received from subsidiaries For example, assume the case of a subsidiary company, the results of which are as follows—

	Profit	*Dividend declared*
Year 1	£1000	Nil
,, 2	£ 800	Nil
,, 3	£1500	Nil
,, 4	£1200	Nil
,, 5	£ 700	£5000

Nothing, it is assumed, was included in the holding company's accounts in respect of any of the results of years 1—4, but the whole of the dividend of £5000 was included in the fifth year It is considered that an indication, that this dividend has come in the main out of profits of a prior period, is obligatory in the directors' statement and preferably also in the Profit and Loss Account of the holding company If this were not disclosed it will be seen that a profit-earning subsidiary might be utilized by unscrupulous directors as a convenient means of artificially "ironing out" the profits of the holding company in that the subsidiary profits could be disregarded in the years in which the holding company's results were satisfactory and an accumulation of back years' profits brought in when the holding company's results happened to be poor and the directors desired to conceal this fact

In the event of the directors refusing to give any indication of the facts on the face of the holding company's Profit and Loss Account it becomes a question whether the circumstances are sufficiently material to warrant the auditor giving the necessary information in his report His decision on this point, it is suggested, should be determined by a consideration of the relationship which the prior years' subsidiary profits bears to the total profits appearing in the holding company's accounts If the prior years' profits represent a material proportion, then it is submitted that the auditor should insist upon the disclosure of this fact, either in the directors' statement or in the auditors' report

In cases where the holding company has guaranteed the preference share capital and dividends of subsidiary companies, a note to this effect should appear on the Balance Sheet of the holding company Such a note appears on the legal Balance Sheet of the Dunlop Rubber Company, appearing in Appendix A

In the case of inter-company transactions, for the reasons given in the preceding chapter, the auditor should ascertain whether any necessary reserve has been made therefor in the holding company's accounts, if not there are circumstances in which it may be necessary for him to qualify his report

The Directors' Statement to be Annexed to the Balance Sheet

In connexion with the requirements of Section 126 Sub-section 1, as to the statement to be annexed to the Balance Sheet relative to the profits and losses of the subsidiary company or companies, it will be observed that this statement has to be signed by the persons by whom the Balance Sheet has been signed, i e two directors, and although the auditor has no responsibility for this statement he is not infrequently consulted as to the form it should take The perusal of many Balance Sheets of holding companies has revealed that seldom is compliance with the requirements of this section strictly observed

Little difficulty arises in those cases in which all the subsidiary companies have made profits and only the dividends which have been declared thereout are brought to the credit of the holding company's Profit and Loss Account Where, however, the dividend from a subsidiary company is declared partly out of profits of a prior period, and the amount is material, it is considered that a clear indication of this fact should be given in the directors' statement

It is in the cases where losses have been sustained that particular care has to be taken in wording the directors' statement Where subsidiaries have sustained losses during the year under review and full provision has been made in the holding company's accounts for such aggregate losses it is open to doubt whether it is sufficient to make the mere statement that "all losses of subsidiary companies have been provided for in the accounts of the holding company" If the auditor should be invited by the directors to advise on the form of the statement, he must in such circumstances consider—

(*a*) How such provision has been made in the holding company's accounts, i e whether or not it has been made out of the profits of the holding company for the year, or, for example, out of the general reserve of the holding company, or partly out of both

(*b*) How the losses have been dealt with in the accounts of the subsidiaries, i e carried forward as an increase in the debit balance on the subsidiary companies' Profit and

Loss Accounts or met in whole or in part out of past undistributed profits of these companies

The statement of the directors appended to the Profit and Loss Account of the Dunlop Rubber Company Ltd (see Appendix A) deals specifically with those two points

A further point of interest emerges in connexion with the case of a subsidiary, which during the year under review makes a profit, but which has sustained losses in preceding years for which full provision has been made in the holding company's accounts For the purpose of illustration let it be assumed that the aggregate losses of a 100 per cent subsidiary company amounted to £10,000 at 31st December, 1935, at which date a corresponding reserve had been set up in the holding company's accounts In the year 1936 this subsidiary earns a profit of say £3000, thereby reducing its aggregate deficit to £7000 In such circumstances it is clearly permissible for the holding company to take £3000 from its own reserve for losses and credit Profit and Loss account If this be done it might appear that the provisions of Section 126 (1) are complied with if the general statement is made that "the profits of a subsidiary company have been applied in reduction of prior losses of that company" Strictly speaking, this is true, but it is considered that the terms of Section 126 lay upon the directors a somewhat wider obligation, as they are required to state not only how the profits are dealt with *in* the accounts of the holding company but also how they are dealt with *for the purposes of* such accounts Now, in the example given above although it could not strictly be said that *the profit of* £3000 earned by the subsidiary had been included in the holding company's Profit and Loss Account, that profit has been used *for the purpose of measuring* to what extent a reduction in the holding company's reserve for losses of £10,000 can be transferred to the credit of its Profit and Loss Account

It is, therefore, submitted that in the circumstances above set forth the directors' statement ought to mention the withdrawal from the previously created reserve for losses in the holding company's accounts and the crediting of its Profit and Loss Account, which it will be observed has been done in the Dunlop Rubber Company's Accounts

in clause (*c*) of the directors' statement (vide page 303, Appendix A)

Before leaving the question of the requirements of Section 126, Sub-section 1, it should be pointed out that the statement may quite properly contain in addition to the bare statutory requirements any information and explanations which the directors may desire to make

Whilst it is appreciated that the foregoing remarks are concerned with matters for which the directors of a holding company are solely responsible, it not infrequently happens that the assistance of an auditor is invoked in drafting or advising upon the precise form of these statements and it is essential that he should have a thorough grasp of the provisions and implications of Section 126 if he is to render effective help in this connexion

Internal Audit of Subsidiaries

Large holding companies commonly have an Internal Audit Department which carries out a continuous audit of the accounts of every company within the group An effective internal audit is of great assistance as a complement to the ordinary audit In this case the shareholders' auditor should inspect the internal audit programmes, and he should also examine the Internal Auditors' Reports upon each company, with a view to becoming familiar with the points raised, how they have been dealt with, and judging whether the internal audit appears to have been carried out effectively

Conclusions

Many complicated and difficult problems arise in connexion with the audit of the accounts of holding companies It is suggested that the general principle upon which the auditor should act is that he must satisfy himself that the accounts, as presented, do give a true and correct view of the position of affairs If, in his opinion, a misleading view is given and the amounts involved are substantial, then the auditor would be running considerable risks if he did not qualify his report accordingly

As regards consolidated statements, the auditor cannot insist on these being presented by the directors to the

shareholders, and if they are, the responsibility for the preparation of such statements falls on the directors. Under the Act, the auditor could not insist upon auditing such statements, but he is commonly asked to do so, and to give a report thereon. If consolidated statements are issued, it is, in the writer's opinion, most desirable that these statements should be audited and reported upon by the company's auditors. In these circumstances, it will be his duty to audit these statements and satisfy himself that they have been prepared upon correct principles, that all necessary adjustments have been made, and that they give a true and correct view of the position of the affairs of the group of companies.

APPENDIX A

DUNLOP RUBBER COMPANY LIMITED

Directors

Chairman—SIR J GEORGE BEHARRELL D S O

Joint Managing Directors—C A PROCTOR and JOHN L COLLYER

SIR CLIVE L BAILLIEU K B E C M G
THE RT HON LORD COLWYN P C
SIR ALEXANDER GIBB G B E C B
SIR S HARDMAN LEVER Bart K C B
F ALEXANDER SZARVASY

Secretary—CHARLES TENNYSON C M G

DIRECTORS' REPORT

The Directors submit the Balance Sheet of the Company as at 31st December 1937 together with the Profit and Loss Account for the year 1937 A Statement of Aggregate Profits for 1937 and a Consolidated Statement of Assets and Liabilities as at 31st December 1937 and a Statement of Comparative results for the years 1933 to 1937 are also submitted

Trading conditions in the Home market during the greater part of 1937 were favourable and also in several Overseas markets

Conditions in the Far East became and continue to be most difficult and violent fluctuations occurred during the year in the price of rubber The price of standard smoked sheet at 31st December, 1936 was 10¼d per lb the price rising rapidly to 1s 1⅞d on the 30th March and falling by the 31st December, 1937 to 7d per lb the average for the year being 9½d per lb This heavy fall in the price of rubber inevitably entailed a substantial write down in the valuation of raw material inventories

The Deutsche Dunlop Gummi Compagnie A G declared a dividend out of the profits of that Company for 1936, and the net amount realized by this Company was £10 279 which amount has been taken to credit in these accounts No credit has been taken in these accounts for the profit earned in 1937 by the German Companies

Trading Results

The net profits for the past five years have been as follows—

	£
1933	1 512 866
1934	1 687 687
1935	1,288 244
1936	1 502,707
1937	1,591,017

From the statement on page 299 it will be seen that the total profits available for appropriation amount to £2 180,973

The Directors appropriations and recommendations are as follows—

	£	s	d
Transfer to Taxation Reserve	495,815	8	4
Transfer to Reserve for Contingencies	250 000	0	0
Preference Dividends paid for the half year to 30th June 1937, *less* Income Tax absorbing	140 625	0	0
The Board proposes paying on the 20th April 1938 dividends on the "A, " B " and C Cum Preference Shares for the half-year to 31st December, 1937 *less* Income Tax at 5s in the £ absorbing	140 625	0	0
The Board proposes the payment of a dividend on the Ordinary Stock of 8 per cent plus a bonus of 1 per cent, both *less* Income Tax at 5s in the £ payable on the 20th April 1938, absorbing	562 479	1	6
Balance carried forward to next account	591,428	16	11
	£2 180 973	6	9

The whole of the Preference Dividends guaranteed by this Company in respect of Dunlop Cotton Mills Ltd Dunlop Rubber Co (India) Ltd and Dunlop Plantations Ltd have been provided for out of the 1937 profits of those Companies

Dunlop Plantations Ltd has in addition repaid out of profits of 1937 the sum of £127 930 6s 5d in respect of Preference Dividends paid by this Company under its guarantee in previous years This amount has been credited to the Company s Profit and Loss Account for 1937

In accordance with established practice provision has been made in these accounts for this Company s proportion of losses incurred during 1937 by any Subsidiary and Associated Companies that have incurred losses and the profits of Subsidiary Companies have been included in this Company s profits only to the extent of (a) dividends declared in respect of the year 1937 (b) the dividend declared by the Deutsche Dunlop Gummi Compagnie A G in respect of the year 1936 and (c) an appropriate amount in respect of the profits earned in 1937 by certain Subsidiary Companies which had previously sustained losses for which this Company had made provision in full

Throughout the organization as in preceding years inventories have been conservatively valued all raw material inventories having been valued at the lower of cost or market prices at the 31st December last Ample provision has been made for bad and doubtful debts and every known loss at home and abroad has been provided for in the accounts

BALANCE SHEET (pp 300 and 301)

The following statement shows in comparative form for 1936 and 1937 the Assets of the Company—

	1936	1937	**Increase** *Decrease*
	£	£	£
Fixed Assets	3 764 616	3 654 522	*110 094*
Investments and Advances	14 543 007	15 338 313	**795,306**
Current Assets	6 410 037	6 217 575	*192 462*
	£24 717 660	25 210 410	**492,750**

Fixed Assets —Adequate provision has been made for depreciation and all Fixed Assets have been thoroughly maintained

Investments and Advances —The increase of £795 306 represents mainly the provision of additional capital for various subsidiaries in order to finance an increased volume of business

The Capital and Liabilities are as follows—

	1936	1937	**Increase** *Decrease*
	£	£	£
Share Capital	12 733 023	12 733 023	—
Surplus and Reserves	5 146 355	5 409 329	**262,974**
	£17 879 378	18,142 352	**262,974**
Debenture Stock	3 433 135	3 390 375	*42 760*
Amounts owing to Subsidiary and Associated Companies	1 438 860	1 533 240	**94,380**
Current Liabilities and Provisions	1 966 287	2 144,443	**178,156**
	£24 717 660	25 210 410	**492,750**

Surplus and Reserves —As already stated the Directors have transferred from Profit and Loss Account the sum of £250 000 to the credit of the Reserve for Contingencies

CONSOLIDATED STATEMENT OF ASSETS AND LIABILITIES (pp 304 and 305)

Owing to the continuance of the Exchange restrictions in Germany and for the reasons explained in previous reports the various items from the Balance Sheets of the German Companies have not been included in the Consolidated Statement

The investments in and advances to these Companies are therefore shown separately under Item II (*d*) on page 305 Under a special arrangement advances amounting to £105 195 were made in 1934 5 and these were repaid in 1937 which accounts for the decrease in this item

COMPARATIVE RESULTS, 1933 1937

Comparative results for the past five years are given on pages 306 to 307 with a view to enabling shareholders to obtain a clear view of the main trends of the Company s financial position

The Director due to retire by rotation is Sir S Hardman Lever Bart K C B and he offers himself for re election

The Auditors Messrs Stokes Brothers & Pim and Messrs Whinney Smith & Whinney retire and being eligible offer themselves for re appointment

By Order of the Board

J GEORGE BEHARRELL *Chairman*
C A PROCTOR } *Joint Managing Directors*
JOHN L COLLYER }
C TENNYSON *Secretary*

25th March 1938

STATEMENT OF PROFITS for the Year 1937

1936 £			
2 200 392	I THE AGGREGATE PROFITS OF THE DUNLOP RUBBER CO, LTD, for the year 1937 including its proportion of the profits *less* losses of all Subsidiary and Sub subsidiary Companies after providing for Depreciation etc but before providing for guaranteed Preference Dividends of Subsidiary Companies amount to		2 478 000
18 764	II IN ADDITION, the Dunlop Rubber Company's proportion of various items which do not represent normal earnings attributable to the current year amounts to		25 926
2 219 156	III AGGREGATE TOTAL		2 503 926
	IV FROM THE RESULTS OF SUBSIDIARY AND SUB SUBSIDIARY COMPANIES INCLUDED ABOVE THERE HAS BEEN DEDUCTED—		
243,496	(*a*) The Dunlop Rubber Company's proportion of British and Foreign Taxation paid by or provided in the accounts of such companies	355 407	
114 375	(*b*) The whole of the Guaranteed Preference Dividend of Dunlop Plantations Ltd, for the year to 30th November 1937 paid by that Company	112 500	
111 515	(*c*) The whole of the Guaranteed Preference Dividend of Dunlop Cotton Mills, Ltd for the year to 31st January 1938 paid by that Company	109 687	
13 595	(*d*) The whole of the Guaranteed Preference Dividend of Dunlop Rubber Co (India), Ltd for the year to 31st December 1937, paid by that Company	13 575	
72 620	(*e*) The Dunlop Rubber Company's proportion of special appropriations and undistributed profits of the year held in reserve	162 497	753 666
555 601			
1 663,555	V BALANCE AVAILABLE TO THE DUNLOP RUBBER CO, LTD, as per that Company's Profit and Loss Account (pages 302 and 303)		1,750,260
160,848	VI DEDUCT Interest on Debenture Stock and Loans		159 243
1 502 707	VII LEAVING THE NET PROFIT AS PER THE DUNLOP RUBBER COMPANY'S PROFIT AND LOSS ACCOUNT (pages 302 and 303)		1 591,017
589 940	VIII Add Balance brought forward from last year		589 956
£2,092,647	IX. TOTAL AVAILABLE		£2 180 973

Balance Sheet as at

1936 £		Authorized Shares and Stock £	Issued Shares and Stock £	£
	I SHARE CAPITAL—			
	1 000 000 6½% 'A Cum Pref Shares of £1 each	1 000 000	1 000 000	
	1 000 000 7% B Cum Pref Shares of £1 each	1 000 000	1 000 000	
	3 000 000 10% 'C Cum Pref Shares of 16s each	2 400 000	2 400 000	
	£15 600 000 Ordinary Stock	15 600 000	8 333 023	
12 733 023		£20 000 000		12 733 023
	II SURPLUS AND RESERVES—			
1 150 832	(a) General Reserve (including balance of Share Premium Account)		1 150 832	
2 315 000	(b) Special Reserve—against investments in and advances to Subsidiary Companies		2 315 000	
	(c) Reserves for Contingencies	782 006		
	Add Transfer from Profit and Loss Account (page 302)	250,000		
790,106			1 032 006	
250,000	(d) Dividend Equalization Reserve		250 000	
50 461	(e) Reserve for Inter Company Profits in Inventory Valuations of Subsidiary Companies		70 062	
589 956	(f) Surplus i e Profit and Loss Account Balance after providing for proposed dividends and Bonus as per Profit and Loss Account (page 302)		591 429	
5,146 355				5 409 329
17 879 378				18 142 352
	III DEBENTURES secured upon assets of the Company—			
	4% Debenture Stock		3,500,000	
	Less Redeemed and cancelled to date		109,625	
3,433 135				3 390 375
	IV AMOUNTS OWING TO SUBSIDIARY AND ASSOCIATED COMPANIES— (*Less* Dividends since declared)			
	(a) Subsidiary Companies		1,494,268	
	Less Company s own Debenture Stock included therein		11,028	
1,388,686			1,483,240	
50,174	(b) Associated Companies		50 000	
1 438,860				1 533 240
	V CURRENT LIABILITIES AND PROVISIONS—			
685 215	(a) Sundry Creditors including accrued Debenture Interest		726,339	
566 250	(b) Taxation Reserve		715 000	
	(c) Proposed Dividends—			
142 969	Preference Dividends for half year to 31st December, 1937 *less* Income Tax		140,625	
571 853	Ordinary Dividend and Bonus for the year to 31st December 1937 *less* Income Tax		562 479	
1,966,287				2 144,443
24 717 660				£25 210 410

Report of the Auditors to the Members of the Dunlop Rubber Company, Limited

In accordance with the provisions of Section 134 sub section 1 of the Companies Act 1929, we report as follows—

We have audited the above Balance Sheet with the books of the Company in which have been incorporated the Returns from Branches certified by Local Auditors or the Branch Officials and we have obtained all the information and explanations we have required In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company s affairs according to the best of our information and the explanations given to us and as shown by the books of the Company and the said Returns

21st March 1938

1936			
£	I FIXED ASSETS at Cost *less* Realizations and Depreciation—	£	
1 814 954	(a) Freehold Land and Buildings	1 729 040	
333 526	(b) Leasehold Premises	330 561	
847 051	(c) Plant Machinery Tools and Moulds	839 069	
116 814	(d) Furniture Fittings and Fixtures	105 220	
13 198	(e) Cars and Delivery Vans	11 808	
639 073	(f) Patents Trade Marks Licences and Royalty Agreements as valued by the Directors at 31st December 1926 *plus* additions at cost *less* sales and amounts written off	638 824	
3 764 616			3 654 522
	II INVESTMENTS AND ADVANCES at Cost *less* amounts written off and Reserves—		
	Subsidiary Companies		
6 365 943	(a) Shares	7 040 034	
7 046 198	(b) Advances and Current Account (including dividends since declared)	7 092 615	
13,412 141	(In respect of this amount there is a Special Reserve of £2 315 000 as *per contra*)	14 132 649	
	Associated Companies		
1 003 599	(c) Shares	1 002,349	
94 983	(d) Advances and Current Accounts	114 410	
	Sundry Investments		
30 500	(e) Cash in Hands of Trustees for Debenture Holders	86,724	
1 784	(f) Trade Investments	2 181	
14 543 007			15 338,313
	III CURRENT ASSETS—		
2 859 632	(a) Inventories of finished and unfinished goods raw materials and stores etc at or below cost as certified by the Company s Officials	3 237 682	
992 274	(b) Sundry Debtors *less* Reserves	1,168 264	
37,296	(c) Leasehold Redemption Policy at Surrender Value	41,971	
106 806	(d) Bills Receivable	108,245	
7 500	(e) Other Securities at Cost	7 500	
2,374 220	(f) Bank Balances Deposits Cash in Hand and in Transit	1 616 746	
32 309	(g) Deferred Charges	37 167	
6 410,037			6,217 575
£24 717,660	NOTE —The Company has guaranteed the Preference Shares of Dunlop Cotton Mills Ltd Dunlop Plantations Ltd and the First Preference Shares of Dunlop Rubber Co (India) Ltd as regards Capital Premium and Dividends and is also contingently liable in respect of the guarantee of Bank advances to certain Subsidiary and Associated Companies		£25 210 410

STOKES BROS & PIM
WHINNEY SMITH & WHINNEY, } *Auditors*
Chartered Accountants

J GEORGE BEHARRELL, *Chairman*
C A PROCTOR, JOHN L COLLYER } *Joint Managing Directors*
F R M DE PAULA *Controller of Finance*

DUNLOP RUBBER

Dr **Profit and Loss Account**

1936 £				£
351 248	I	To Depreciation		337 610
8 000	II	,, Directors Fees		8,000
1 663 555	III	,, Balance carried down		1 750 260
2 022 803				£2 095 870
160,848	IV	To Interest on Debenture Stock and Loans		159,243
1 502 707	V	Net Profit carried down		1 591 017
1 663 555				£1 750 260
394 900	VI	To Transfer to Taxation Reserve		495,815
100 000	VII	,, Transfer to General Reserve		—
150 000	VIII	,, Transfer to Reserve for Contingencies		250 000
	IX	PREFERENCE DIVIDENDS	£	
142 969		(a) Half year to 30th June 1937 (already paid) *less* Income Tax	140 625	
142 969		(b) Proposed for the half year to 31st December 1937, *less* Income Tax	140,625	281,250
	X	,, ORDINARY DIVIDEND AND BONUS		
571 853		Proposed for the year to 31st December 1937, *less* Income Tax		562,479
589,956	XI	Balance carried forward as per Balance Sheet		591 429
£2 092 647				£2 180 973

COMPANY, LIMITED
for the Year ended 31st December, 1937 Cr

1936			
£			£
2 011 768	I	By Profit on Trading Interest Dividends on Investments including those received from or since declared by Subsidiary and Associated Companies and Miscellaneous Receipts	1 957 661
11 035	II	, Repayment on account of Guaranteed Preference Dividends paid by the Dunlop Rubber Co Ltd in previous years Dunlop Plantations Ltd	127 930
——	III	Net Dividend received from the Deutsche Dunlop Gummi Cie A G in respect of the year 1936	10 279
2 022 803			£2 095 870
1 663 555	IV	By Balance brought down	1 750 260
1 663 555			£1 750 260
1 502 707	V	By Net Profit brought down	1 591 017
589 940	VI	Balance brought forward from 1936	589,956
£2 092 647			£2,180 973

NOTE —The Profits of Subsidiary Companies are included in the profits of this Company to the extent of (a) the dividends declared in respect of the year 1937, (b) a dividend declared by the Deutsche Dunlop Gummi Compagnie A-G in respect of the year 1936 and (c) an appropriate amount in respect of the profits earned in 1937 by certain Subsidiary Companies which had previously sustained losses for which this Company had made provision in full
Certain Subsidiary Companies sustained losses in 1937 and full provision for this Company s proportion thereof has been made out of the profits above set forth
In the accounts of the Subsidiary Companies these losses have been carried forward to the extent to which they are not provided for out of undistributed profits of those Companies

J George Beharrell,
C A Proctor
John L Collyer
Directors

CONSOLIDATED STATEMENT OF ASSETS

DUNLOP RUBBER COMPANY LIMITED

Incorporating the figures of the audited Balance Sheets (after elimination of inter company balances) exceptions stated under the heading of Investments item II (d) below) in which the Dunlop Rubber companies and over 50% of the voting control

1936 £		£	£
	I ISSUED SHARE CAPITAL OF THE DUNLOP RUBBER COMPANY, LIMITED—		
	1 000 000 6½% A Cum Pref Shares of £1 each fully paid	1 000 000	
	1 000 000 7% 'B do do do	1 000 000	
	3 000 000 10% C Cum Pref Shares of 16s each fully paid	2 400 000	
	£8 333,023 Ordinary Stock	8 333 023	
12 733 023			12 733 023
	II SURPLUS AND RESERVES—		
1,336 199	(a) General Reserves	1 370 175	
	(b) Special Reserve in the accounts of the Dunlop Rubber Company Limited in respect of Subsidiary Companies		
2 315 000		2 315 000	
790,106	(c) Reserves for Contingencies	1 123,005	
250 000	(d) Dividend Equalisation Reserve	250 000	
	(e) Surplus i e , Profit and Loss Account Credit Balances after providing for Proposed Dividends and Bonus		
689 066		697 377	
5 380,371			5 761 557
18 113 394			18 494 580
	III INTEREST OF OUTSIDE SHAREHOLDERS—		
	Preference and Ordinary Share Capital of Subsidiaries held by Outside Shareholders after taking into account their proportion of General Reserves and Undistributed Profits or Losses attributable thereto		
6 020 550			5 993 883
	IV DEBENTURE STOCK, MORTGAGES AND LOANS—		
	(a) Dunlop Rubber Company Limited, Debenture Stock 3,390 375		
	Less—Held by Subsidiary Company 11 028		
3 422 107		3 379,347	
558 233	(b) Loans	390 075	
10 138	(c) Mortgage	10 000	
3 990 478			3,779,422
	V CURRENT LIABILITIES AND PROVISIONS—		
1 852 766	(a) Sundry Creditors and Accrued Charges	2 120 822	
54 396	(b) Amounts owing to Associated Companies	53 489	
869,860	(c) Taxation Reserves	1,144 385	
	(d) Proposed Dividends—		
714,822	Dunlop Rubber Company Limited Dividends and Bonus	703,104	
161 175	Dividends of Subsidiaries to Outside Shareholders	153 762	
3 653 019			4 175 562
10 558	**VI. EXCHANGE SUSPENSE ACCOUNTS, BEING AMOUNTS RESERVED FOR UNREALISED EXCHANGE DIFFERENCES**		12 115
£31,787 999			£32 455 562

We have examined the above Consolidated Statement of Assets and Liabilities with the Balance Sheet of the Dunlop Rubber Company Ltd at 31st December, 1937 as audited by us, and with the Balance Sheets of the Subsidiary and Sub subsidiary Companies as audited by their respective Auditors In the case of certain Subsidiary Companies the Balance Sheets are at dates other than 31st December, 1937 and the adjustments consequent thereon have been made In our opinion the statement set forth above has been correctly compiled from the said Balance Sheets (other than those of the Companies in Germany) after giving effect to the necessary adjustments in respect of Foreign Exchange so as to exhibit a true and correct view of the consolidated position of the Companies at 31st December, 1937

21st March, 1938

STOKES BROS & PIM,
WHINNEY, SMITH & WHINNEY } *Chartered Accountants*

AND LIABILITIES as at 31st December, 1937

AND SUBSIDIARY COMPANIES

of the Dunlop Rubber Company Limited and all Subsidiary and Sub subsidiary Companies (with two Company Limited and any of its Subsidiaries hold over 50% of the Ordinary Shares or Stock of those

1936 £				
	I	**FIXED ASSETS,** at cost *less* realizations and provisions for depreciation and obsolescence—		
10 283 592		(a) Land Factory and other Buildings Cotton Mills Plant Tools Furniture Cars etc	10 161 435	
4 149 116		(b) Dunlop Plantations Ltd Estates Buildings Plant etc	4 093 505	
639 074		(c) Patents Trade Marks Licences etc	638 824	
15 071 782				14 893 764
	II	**INVESTMENTS,** at Cost *less* amounts written off—		
1 057 758		(a) Investments in Associated Companies	1 051 371	
30 500		(b) Cash in hands of Trustees for Debenture Holders	86 724	
13 489		(c) Trade and Sundry Investments	15 104	
458 964		(d) Investments in German Companies Shares and Advances	353 769	
1,560 711				1 506 968
	III	**CURRENT ASSETS—**		
7 332 013		(a) Inventories at or below cost	8 859 843	
3 676 581		(b) Sundry Debtors Bills Receivable etc *less* Reserves	3 977 785	
107,171		(c) Amounts owing by Associated Companies	136 214	
62 326		(d) Other Securities	66 007	
2 449 104		(e) Bank Balances and Cash *less* Bank Loans	1 355 196	
124 466		(f) Deferred Charges	141 727	
13 751 661				14 536 772
1 386 373	IV	**GOODWILL ACCOUNTS,** including the difference between the values at which inter company holdings of shares are taken as assets into the Balance Sheets and their Par values *less* undistributed profits at the date of the acquisition of such shares		1 485 765
17 472	V	**SUSPENSE ACCOUNT** for transactions with Subsidiary Companies between the dates of their Balance Sheets and 31st December, 1937		32 293
£31 787 999				£32 455,562

NOTE —For the reasons given in the Directors Report (page 298) the investments in and advances to the German Companies as at the 31st December 1937 are shown separately under Item II (d) above and consequently the Assets and Liabilities of those companies have not been classified under their respective headings

J GEORGE BEHARRELL *Chairman*
C A PROCTOR, JOHN L COLLYER, } *Joint Managing Directors*
F R M DE PAULA *Controller of Finance*

COMPARATIVE RESULTS 1933—1937

STATEMENT OF PROFITS	1933	1934	1935	1936	1937
	£	£	£	£	£
I The Aggregate Profits of the Dunlop Rubber Co, Ltd, including its proportion of the profits less losses of all Subsidiary and Sub-subsidiary Companies after providing for Depreciation etc but before providing for guaranteed Preference Dividends of Subsidiary Companies	2 255 973	2 276 336	1 860 073	2 200 392	2 478 000
II The Dunlop Rubber Company's proportion of various items which do not represent normal earnings attributable to the current year	90 671	9 183	9 128	18 764	25 926
III Aggregate Total	2 346 644	2 285 519	1 869 201	2 219 156	2 503 926
IV From the results of Subsidiary and Sub subsidiary Companies included above there has been deducted—					
(a) The Dunlop Rubber Company's proportion of British and Foreign Taxation paid by or provided in the accounts of such companies	229 440	167 895	104 752	243 496	355 407
(b) Guaranteed Preference Dividends	164 859	243 153	243 199	259 485	235 762
(c) The Dunlop Rubber Company's proportion of special appropriations and undistributed profits of the year held in reserve	83 421	47 932	61 887	72 620	162 497
	477 720	458 980	409 838	575 601	753 666
V Balance available to the Dunlop Rubber Co, Ltd	1 863 924	1 826 539	1 459 363	1 663 555	1 750 260
VI. Deduct—					
(a) **Guaranteed Preference Dividends** of Subsidiary Companies borne by the Dunlop Rubber Co Ltd	65 882	—	—	—	—
(b) **Interest on Debenture Stock, etc**	285 176	138 852	171 119	160 848	159 243
VII Leaving the Net Profit as per the Dunlop Rubber Company's Profit and Loss Accounts	1 512 866	1 687 687	1 288 244	1 502 707	1 591 017
VIII. Add Balance brought forward	442 208	578 415	588 652	589 940	589 956
IX. Total available	£1 955 074	£2 266 102	£1 876 896	£2 092 647	£2 180 973

NOTE —The 1934, 1935 and 1937 profits made in Germany are not included in the above statement. Included in the 1937 profits is a dividend received in respect of the year 1936

	1933	1934	1935	1936	1937
ANNUAL APPROPRIATIONS OF AVAILABLE PROFITS 1933 1937—	£	£	£	£	£
I Transfer to Taxation Reserve	403 956	550 060	419 761	394 900	495 815
II Transfer to General Reserve	200 000	—	—	100 000	—
III Transfer to Reserve for Contingencies	—	100 000	100 000	150 000	250 000
IV Transfer to Dividend Equalisation Reserve	—	250 000	—	—	—
V Dividends on the A B and C Cum Preference Shares (less Income Tax)	285 938	290 625	288 281	285 938	281 250
VI Dividend on the Ordinary Stock (less Income Tax)	486 765 (8%)	486 765 (8%)	478 914 (8%)	571 853 (8% + Bonus 1%)	562 479 (8% + Bonus 1%)
VII Balance carried forward	578 415	588 652	589 940	589 956	591 429
	£1 955 074	£2 266 102	£1 876 896	£2 092 647	£2 180 973
DUNLOP RUBBER CO, LTD					
Issued Share and Loan Capital	14 592 016	15 040 412	15 725 305	16 166 158	16 123 398
Surplus and Reserves—					
I General Reserve	1 124 843	1 124 843	1 124 843	1 150 832	1 150 832
II Special Reserve—against investments in and advances to Subsidiary Companies	2 000 000	2 000 000	2 000 000	2 315 000	2 315 000
III Reserves for Contingencies	643 260	645 443	692 027	790 106	1 032 006
IV Dividend Equalization Reserve	—	250 000	250 000	250 000	250 000
V Reserve for Inter-Company Profits in Inventory Valuations of Subsidiary Companies	369	46 998	32 922	50 461	70 062
VI Surplus i e Profit and Loss Account Balance after providing for proposed dividends	578 415	588 652	589 940	589 956	591 429
	£4 346 887	£4 655 936	£4 689 732	£5 146 355	£5 409 329
SURPLUS OF CURRENT ASSETS OVER CURRENT LIABILITIES					
I Dunlop Rubber Co Ltd (pages 300 and 301)	3 193 550	3 623 415	4 274 111	4 443 750	4 073 132
II Consolidated Position (pages 304 and 305)	8 067 034	8 453 194	9 505 539	10 098 642	10 361 210

DUNLOP PLANTATIONS, LIMITED

Directors

Sir J George Beharrell D S O *Chairman*
John L Collyer C A Proctor
Sir S Hardman Lever Bart K C B
F D Ascoli C I E *Managing Director* G Wiseman *Resident Director*

Secretary—C Tennyson C M C

DIRECTORS' REPORT

The Directors submit the Balance Sheet as at the 31st October, 1937 together with the Profit and Loss Account for the year 1936 37

Trading Results

The total available Profits and the Directors recommendations, are as follows—

	£	s	d
Balance on Estates Trading Account	498,774	9	3
Less Depreciation of Buildings Plant etc	43 327	6	3
Total available	£455 447	3	0

Appropriations

	£	s	d
Income Tax and National Defence Contribution	75 016	16	7
Amount written off Estates and Development Account	140 000	0	0
Preference Dividend *less* Income Tax paid for the year ended 30th November 1937	112,500	0	0
Repayment on account of Guaranteed Preference Dividends paid in previous years by the Dunlop Rubber Co , Ltd	127 930	6	5
	£455 447	3	0

The net profit for the year of £455 447 compares with £293 102 for 1935 36 representing an improvement of £162,345, which is due to the higher average market price of rubber over the year The sum of £140,000 has been written off the Estates and Development Account The remaining profits enable the Company to pay the full Preference Dividend *less* Income Tax for the year to 30th November 1937 and to repay to the Dunlop Rubber Co Ltd the sum of £127 930 on account of Guaranteed Preference Dividends paid by it in previous years

The total area of the Estates at the 31st October 1937, was 101 051 acres, made up as follows—

	Acres	
Total Planted Area		
Mature	63 944	
Immature	20 980	
		84 924
Total Unplanted Area		
Reserves	8 604	
Swamps Ravines Building Sites etc	7 523	
		16,127
Total		101,051

During the year 3 415 acres of budded rubber were brought into tapping, and an additional acreage will come into tapping this year

BALANCE SHEET

The following statement shows in comparative form for 1936 and 1937 the Assets of the Company—

	1936	1937	Increase *Decrease*
Fixed Assets	£	£	£
Estates and Development less amounts written off to date	3 946 796	3 876 242	*70 554*
Estate Buildings Plant etc	184 049	197 545	**13,496**
Latex Bulking Plants etc	18 271	19,718	**1,447**
Investment	885	—	*885*
	4 150 001	4 093 505	*56 496*
Current Assets	£	£	£
Stock of Rubber	199 872	209,062	**9,190**
Stock of Stores etc	16 696	25 086	**8,390**
Debtors and Deposits	16 990	27 139	**10,149**
Associated Companies	24 049	193 828	**169,779**
Cash and Bank Balances	20 725	32 280	**11,555**
Deferred Charges	6 128	7 017	**889**
	284 460	494,412	**209,952**
Total	4 434 461	4 587 917	**153,456**

Ample provision for Depreciation has been made on Estate Buildings, Plant Latex Bulking Plant etc

The Capital and Liabilities are as follows—

	1936	1937	Increase *Decrease*
Share Capital	£	£	£
Preference Shares	2 500 000	2 500,000	—
Ordinary Shares	270,000	270 000	—
	2 770 000	2,770 000	—
DUNLOP RUBBER CO, LTD Loan Account	1 487 930	1,569 729	**81,799**
Current Liabilities			
Sundry Creditors and Accrued Charges	88 615	114 084	**25,469**
Associated Companies	729	1 854	**1,125**
Taxation Reserve	30 000	76,000	**46,000**
Proposed Dividend	57 187	56 250	*937*
	176 531	248,188	**71,657**
Total	4 434 461	4,587 917	**153 456**

The surplus of Current Assets over Current Liabilities amounts to £246 224 as compared with £107 929 for 1936 representing an increase of £138 295

Mr John L Collyer having joined the Board since the last Annual Meeting retires and Mr G Wiseman retires by rotation Both offer themselves for re election

The Auditors Messrs Whinney Smith & Whinney, retire and being eligible offer themselves for re appointment

By Order of the Board
C TENNYSON *Secretary*

32 38 OSNABURGH STREET
LONDON N W 1
25th March, 1938

DUNLOP PLANT

BALANCE SHEET AS AT

(STRAITS SETTLEMENTS DOLLARS

1936		£	£
£	**SHARE CAPITAL**		
	Authorized—		
	2 500 000 6% Cumulative Pref Shares of £1 each	2,500 000	
	300,000 Ordinary Shares of £1 each	300 000	
		2 800 000	
	Issued—		
2,500 000	2,500 000 6% Cumulative Pref Shares of £1 each fully paid	2 500 000	
270 000	270,000 Ordinary Shares of £1 each fully paid	270,000	
2 770 000			2 770 000
1 487 930	**Dunlop Rubber Company, Ltd —Loan Account**		1 569 729
	CURRENT LIABILITIES		
88 615	Sundry Creditors and Accrued Charges	114 084	
729	Associated Companies	1 854	
30 000	Taxation Reserve	76 000	
57 187	Proposed Preference Dividend for half year to 30th November 1937 *less* Income Tax	56 250	
176 531			248 188
£4 434,461			£4 587 917

Report of the Auditors to the Members of Dunlop Plantations, Ltd

In accordance with the provisions of Section 134 sub section 1, of the Companies Act, 1929, we report as follows—

We have audited the above Balance Sheet with the books of the Company in London and the Audited Accounts from Malacca, and we have obtained all the information and explanations we have required In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company s affairs according to the best of our information and the explanations given to us and as shown by the books of the Company in London and the said Audited Accounts

London, 18*th March* 1938

ATIONS, LIMITED

31st OCTOBER, 1937

CONVERTED AT 2s 4d)

1936			
£	**FIXED ASSETS**		
3 946 796	Estates at Cost and Expenditure on Development to date *less* Amounts written off to date	3 876 242	
184 049	Estate Buildings Plant Vehicles Furniture etc at Cost *less* realizations and depreciation	197 545	
18 271	Latex Bulking Plants etc at Cost *less* depreciation	19 718	
885	Investment at Cost *less* amount written off	—	
4 150,001			4 093 505
	CURRENT ASSETS		
199 872	Stock of Rubber at prices since realized, except £14 857 16s od at estimated realizable value	209 062	
16 696	Stock of Sundry Stores, etc as certified by the Managing Director	25 086	
16 990	Debtors and Deposits	27 139	
24 049	Associated Companies	193,828	
	Cash and Bank Balances—		
17 225	London and Malaya	32 280	
3 500	In transit to Malaya	—	
6 128	Deferred Charges	7 017	
284 460			494 412

NOTE —The Company is contingently liable to repay out of future profits the following amounts paid in respect of Preference Dividends by the Dunlop Rubber Co Ltd under the terms of its Guarantee—

Balance in respect of the year ended 30th November, 1932	£75,371	17	7
For the year ended 30th November 1933	70 882	7	1
	£146 254	4	8

£4 434 461	£4 587,917

WHINNEY SMITH & WHINNEY *Auditors*
Chartered Accountants

J GEORGE BEHARRELL
F D ASCOLI } *Directors*

C TENNYSON *Secretary*

DUNLOP PLANT

Dr **PROFIT AND LOSS ACCOUNT**

1936		
£		£
46,287	To Depreciation of Buildings, Plant, etc	43 327
—	" Directors Fees	—
293 102	" Net Profit carried down	455 447
£339 389		£498 774
27 692	To Income Tax and National Defence Contribution	75 017
140 000	" Amount written off Estates and Development Account	140 000
57,188	" Preference Dividend paid for half year to 31st May 1937 *less* Income Tax	56 250
57,187	" Proposed Preference Dividend for half year to 30th November 1937, *less* Income Tax	56 250
282 067		327,517
11 035	" Balance applied in repayment on account of Guaranteed Preference Dividends paid in the past by the Dunlop Rubber Co, Ltd	127 930
£293 102		£455 447

ATIONS, LIMITED

for the year ended 31st October, 1937 **Cr**

1936		
£		£
339 389	By Balance on Estates Trading Account including Sale of Export Rights and Miscellaneous Receipts and after deducting London Office Expenses	498 774
£339 389		£498 774
293 102	By Net Profit brought down	455 447
£293 102		£455 447

DUNLOP COTTON MILLS, LIMITED

Directors

SIR J GEORGE BEHARRELL D S O *Chairman*
THE RT HON LORD COLWYN P C F ALEXANDER SZARVASY
JOHN L COLLYER SIR S HARDMAN LEVER Bart K C B
THOMAS E ANDREW *Managing Director*

Secretary—C TENNYSON C M G

DIRECTORS' REPORT

The Directors submit the Balance Sheet at the 31st December 1937 together with the Profit and Loss Account for the year 1937

Trading Results

The total available Profits and the Directors recommendations are as follows—

	£	s	d
Profit on Trading including Interest and Miscellaneous Receipts	306,828	16	
Less Depreciation	97 781	7	5
Net Profit for the Year	209 047	8	10
Balance brought forward from last year	11 779	15	7
Total available	£220 827	4	5

Appropriations

Transfer to Income Tax and National Defence Contribution Reserve	69 750	6	3
Preference Dividends paid for the year ended 31st January 1938 *less* Income Tax	109 687	10	0
The Board proposes the declaration and payment of a Dividend free of Income Tax on the Ordinary Shares of	29 500	0	0
Balance carried forward to next account	11 889	8	2
	£220 827	4	5

The net profit for the year after providing for depreciation, is £209,047 as compared with £228 115 for 1936, representing a decrease of £19,068

The decrease in profits is mainly due to lower prices charged to associated companies The volume of business again increased over that of the preceding year

The Raw Cotton market prices advanced steadily until April when the break in prices occurred The average prices paid by the Company for the full year were slightly above those for the preceding year

BALANCE SHEET

The following statement shows in comparative form for 1936 and 1937 the Assets of the Company—

	1936	1937	**Increase** *Decrease*
Fixed Assets	£	£	£
Land and Buildings	818 130	794 450	*23 680*
Steam and Electric Plant	96 590	78 100	*18,490*
Textile Plant	352,150	304 790	*47 360*
Office Furniture	150	205	**55**
Investments	685	685	—
Motor Car	—	230	**230**
	£1 267 705	1 178 460	*89 245*

Current Assets	£	£	£
Inventories	290 072	246 883	*43 189*
Sundry Debtors (*less* Reserves)	10 108	5 572	*4 536*
Associated Companies	33 347	51 238	**17,891**
Dunlop Rubber Co Ltd —Current Account	1 091 010	1 169 009	**77,999**
Marketable Securities	11,028	11 028	—
Bank Balance	296	359	**63**
Deferred Charges	3 369	17 442	**14,073**
	£1 439 230	1 501 531	**62,301**
Total	£2 706 935	2 679 991	*26 944*

Additions to Fixed Assets during 1937 have been normal and the usual full provision for depreciation etc has been made the net effect being a decrease in Fixed Assets of £89 245

Inventories have been valued on the usual conservative basis

Current Assets in total have increased by £62 301 which is mainly accounted for by an increase of £77 999 in the Current Account with the Dunlop Rubber Co , Ltd

The Capital and Liabilities are as follows—

	1936	1937	**Increase** *Decrease*
Share Capital and Reserves	£	£	£
Preference	2 250 000	2 250 000	—
Ordinary	250 000	250 000	—
Profit and Loss Account	11 780	11,889	**109**
	£2 511 780	2 511 889	**109**
Current Liabilities			
Sundry Creditors	38 397	25 758	*12 639*
Income Tax and National Defence Contribution Reserve	36 000	58 000	**22,000**
Proposed Dividends—			
Preference	55 758	54 844	*914*
Ordinary	65 000	29 500	*35 500*
	£195,155	168 102	*27 053*
Total	£2 706 935	2 679 991	*26 944*

Current Liabilities have decreased during the year by £27,053 mainly due to the decrease of £35 500 in the Ordinary Dividend payable and a decrease of £12 639 in Sundry Creditors partly offset by an increase of £22 000 in Income Tax and N D C Reserve

The surplus of Current Assets over Current Liabilities is as follows—

	1936	1937	**Increase** *Decrease*
	£	£	£
Current Assets	1 439 230	1 501,531	**62,301**
Current Liabilities	195 155	168 102	*27 053*
Surplus	£1 244 075	1 333 429	**89,354**

The Director due to retire by rotation is the Rt Hon Lord Colwyn P C and he offers himself for re election Sir S Hardman Lever Bart K C B , and Mr John L Collyer having been elected to the Board since the last Annual General Meeting also retire and offer themselves for re election

The Auditors, Messrs Whinney Smith & Whinney retire and being eligible offer themselves for re appointment

By Order of the Board

C Tennyson, *Secretary*

32 38 Osnaburgh Street
London, N W 1
25th March 1938

DUNLOP COTTON
BALANCE SHEET AS

1936		£	£
£	**SHARE CAPITAL**		
	Authorized and Issued—		
2 250 000	2,250,000 6½% Cumulative Pref Shares of £1 each	2 250 000	
250 000	250,000 Ordinary Shares of £1 each	250 000	
			2 500 000
2 500 000			
	PROFIT AND LOSS ACCOUNT		
11 780	Balance after providing for proposed dividends		11 889
2 511,780			2 511 889
	CURRENT LIABILITIES		
38 367	Sundry Creditors and Accrued Charges	25 758	
30	Associated Companies	—	
36 000	Taxation Reserve	58 000	
	Proposed Dividends—		
55,758	Preference Dividend for half year to 31st January 1938, *less* Income Tax	54 844	
65 000	Ordinary Dividend	29 500	
			168 102
195 155			
	NOTE—There is a Contingent Liability for bills under discount amounting to £3,681		
£2,706 935			£2,679 991

Report of the Auditors to the Members of Dunlop Cotton Mills, Ltd

In accordance with the provisions of Section 134 sub section 1 of the Companies Act 1929 we report as follows—

We have audited the above Balance Sheet and have obtained all the information and explanations we have required In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company s affairs according to the best of our information and the explanations given to us and as shown by the books of the Company

London 18*th March*, 1938

MILLS, LIMITED

AT 31st December, 1937

1936 £		£	£
	FIXED ASSETS (At cost less realizations and amounts written off)—		
818 130	Land and Buildings	794 450	
96 590	Steam and Electric Plant	78 100	
352 150	Textile Plant	304 790	
150	Office Furniture	205	
685	Investments	685	
—	Motor Car	230	1 178 460
1 267 705			
	CURRENT ASSETS		
290 072	Inventories as certified by Managing Director	246 883	
	Sundry Debtors—		
10 108	Trade Accounts *less* reserves	5 572	
33,347	Associated Companies	51 238	
1,091 010	Dunlop Rubber Co Ltd —Current Account	1,169 009	
11 028	£11,028 Dunlop Rubber Co , Ltd , 4% Mortgage Debenture Stock at cost (Market Value at 31st December, 1937 £11,249)	11,028	
296	Bank Balance	359	
3,369	Deferred Charges	17 442	1 501 531
1 439 230			
£2 706 935			£2 079 991

WHINNEY, SMITH & WHINNEY *Auditors*
Chartered Accountants

J GEORGE BEHARRELL, THOMAS E ANDREW } *Directors*

C TENNYSON, *Secretary*

DUNLOP COTTON

Dr **PROFIT AND LOSS ACCOUNT**

1936 £		£
102 146	To Depreciation	97,78
—	, Directors Fees	—
49 435	, Income Tax and National Defence Contribution	69 750
55 758	Preference Dividend paid for half year to 31st July 1937, *less* Income Tax	54 844
	Proposed Dividends—	
55 758	Preference for half year to 31st January, 1938, *less* Income Tax	54 844
65 000	Ordinary for year to 31st December 1937 free of Income Tax	29 500
11 780	, Balance carried forward as per Balance Sheet	11 889
£339 877		£318 609

MILLS, LIMITED

for the yeaı ended 31st December, 1937 Cı

1936		
£		£
330 262	By Profit on Tradıng ıncludıng Interest and Mıscellaneous Receıpts	306 829
9 615	, Balance brought forward from last account after appropriatıons	11 780
£339,877		£318 609

APPENDIX B

EXAMINATION QUESTIONS

(1) What are the principal objects of an audit?

(2) State briefly the difference in principle between the audit of the accounts of a private partnership and those of a limited company

(3) What do you understand by a "Continuous Audit," and what are the advantages and disadvantages of such an audit?

(4) Upon having been appointed auditor of (*a*) a company (*b*) a partnership what would you do in each case before commencing the actual work of the audit?

(5) What are the objects of keeping an Audit Programme?

(6) What do you understand by "Internal Checks," and what is an auditor's position in regard thereto?

(7) What notes should an auditor make during the course of an audit?

(8) What steps would you take to discover an error in the Trial Balance of a set of books, which the staff of the company had failed to detect, and which you were asked to find?

(9) What do you understand by the term "Vouching"?

(10) State in detail the work involved in a complete and efficient audit of the Cash Book of a manufacturing business

(11) To what special points should an auditor pay attention when checking the Banker's Pass Book with the Cash Book? State how you would verify the Balance at Bank and the Cash in Hand

(12) Describe the steps that you would take as auditor to check the following—

Cash Sales
Rents Receivable
Interest Receivable on Loans
Proceeds of sale of £500 Consols

(13) Why would you consider endorsed cheques to be insufficient vouchers for the payment of accounts? Under what circumstances if any would you accept endorsed cheques as vouchers for any payments?

(14) In vouching a Cash Book you find the following payments What proof would you require of the correctness of the payment in each case?

Travellers' Commissions and Expenses
Staff Salaries
Payments to builders on account of a contract for the erection of buildings
Purchase of Plant and Machinery
Purchase of some Debentures of a Railway Company
Payment of Bought Ledger Accounts

(15) You are consulted as auditor of a manufacturing company, employing a large number of operatives, some of whom are day and some piece workers, as to the mode in which the wages should be recorded and the payment checked

State what you would recommend under both heads, and, if the system you suggest were adopted, to what extent would you, as auditor, check the wages?

(16) In what way would you audit a Petty Cash Account?

(17) A firm of iron merchants, for whom you act as auditor, has contracted to purchase 5000 tons of iron at £2 10s per ton, on terms of six months acceptances from date of invoice The iron had been delivered as follows—

15th April,	2000 tons
15th June,	2000 tons
15th October,	1000 tons

What books of the firm would it be requisite for you to see in examining the record of these transactions? How would the liability in respect of it be shown in the Balance Sheet of 31st December following?

(18) In auditing the accounts of a trading company, what steps would you, as auditor take to ascertain if the amounts charged in respect of purchases were correct?

(19) How would you satisfy yourself, as auditor that the Reserve for Bad and Doubtful Debts was a sufficient one?

(20) How would you vouch the entries contained in the Journal?

(21) To what points should an auditor pay special attention when examining invoices?

(22) Describe the steps that you would take to check the Bought Day Book

(23) In auditing the accounts of a manufacturing business you are asked particularly to ascertain that all outstanding accounts have been brought in How would you satisfy yourself on this point? Give illustrations

(24) What are the duties of auditors with reference to the grouping of the items in a Balance Sheet? What evils have to be avoided? What general principles should be acted upon?

(25) What items would you expect to find in the "Manufacturing Account," 'Trading Account," "Profit and Loss Account,' and "Appropriation Account" of (*a*) a Company and (*b*) a partnership, and what are the objects of preparing these several accounts?

(26) Define a Balance Sheet, and explain why in the majority of cases it is not a Statement of Assets and Liabilities?

(27) What do you understand by ' Fixed" and "Floating" or "Current" Assets, and upon what basis should they respectively be valued for Balance Sheet purposes?

(28) What are an auditor s responsibilities as regards the valuation of assets?

(29) What do you understand by "the Verification of Assets," and what are the objects of such a verification?

(30) State briefly how you would verify the following, and also what evidence you would require, as auditor, of the values of these assets in a limited company's Balance Sheet—

(*a*) Freehold Land and Premises
(*b*) Fixed and Loose Plant
(*c*) Inscribed Stocks
(*d*) Goods on Consignment
(*e*) Cash in Hand
(*f*) Bonds to Bearer
(*g*) Shares in Joint Stock Companies

(31) Upon what principles should Stock-in-Trade be valued, and to

what extent would you, as auditor, check the stock of a manufacturing company?

(32) In a brewery, 100 pockets of hops in stock cost £5 per pocket How should they be stated in the Balance Sheet, if the present value be (*a*) £4 per pocket, or (*b*) £6 per pocket? Give your reasons

(33) How should the Investments belonging to a company be valued for Balance Sheet purposes?

(34) In the Balance Sheet of a financial company there is the following asset—

"Investments, including Consols, English Railway Debentures and other Securities, £100,000"

You find, on inquiry, that the Consols and English Railway Debentures represent only a very small proportion of the £100 000, and that the "other securities" are altogether of a second-rate nature What do you consider to be the duty of an auditor in these circumstances?

(35) A firm is in the habit of giving and taking a considerable number of "Bills Payable" and "Bills Receivable," and frequently discounts the latter Four months elapse before the Balance Sheet is presented to you for audit What steps would you take to verify the "Bills Payable" and "Receivable" existing at the date of the accounts?

(36) In examining the books of a company manufacturing stove grates, which closes its books on the 31st March, you observe three invoices respectively for pig iron, sand and fire bricks purchased, which had been entered in the Bought Day Book on the 22nd, 27th, and 28th March, ruled through and entered on the 2nd April as purchases of the next financial year

What would this suggest to you, and what steps would you take to satisfy yourself that the Trading Account and Balance Sheet were correct?

(37) Upon what basis would you expect to find the unsold production valued for Balance Sheet purposes in the case of a rubber estate? Give reasons for your answer, and explain how, as auditor, you would verify this stock

(38) How would you verify the item "Uncompleted Contracts" in the case of a public works contractor and appearing in his Balance Sheet?

(39) Are there, in your opinion, any circumstances which would justify the addition of any anticipated profit to actual cost in the case of partially manufactured goods, or of an uncompleted engineering contract, or in similar cases?

(40) How should Plant and Machinery be valued for Balance Sheet purposes in the case of a manufacturing company?

(41) In the event of an auditor being of opinion that the provision for depreciation was insufficient, what course should he adopt?

(42) On being appointed auditor of a company which has presented annual Balance Sheets to its shareholders for ten years, you find that some freehold buildings acquired at the formation of the company, and some buildings acquired five years later on a thirty years' lease, are included in the tenth annual Balance Sheet at the prices paid for the freehold and leasehold respectively What course would you advise the directors to adopt with reference thereto, before you certify the eleventh Balance Sheet?

(43) What is Goodwill, and upon what should its valuation be based?

(44) In auditing a Balance Sheet of a shipping company you find a note on the Balance Sheet as follows "Contingent Liability on Bills Receivable discounted, £5000" What does this mean? Is it necessary to verify this statement? If so, how would you satisfy yourself on this point?

(45) What do you understand by Depreciation, and what are the objects of providing for it?

(46) Explain what is meant by—

(*a*) A Specific Reserve
(*b*) A General Reserve
(*c*) A Reserve Fund
(*d*) A Depreciation Fund
(*e*) A Sinking Fund
(*f*) A Capital Reserve

(47) The directors of a manufacturing company, owning a considerable quantity of valuable plant and machinery, decide to keep a Plant Register They request you to advise them as to how this Register should be kept what information should be entered therein, and how the question of depreciation should be dealt with Set out in the form of a report to the directors the advice that you would give

(48) Having suggested the necessity of a provision for Depreciation of Machinery in the accounts of each of three companies, the respective boards of directors raise objection on the following grounds respectively—

(*a*) The cost of similar machinery having risen, nothing should be written off, as it is actually more valuable

(*b*) Repairs done have fully maintained the machinery, which is as good as new

(*c*) To charge depreciation to the same extent as in a good year would prevent the declaration of a dividend, with the result of dissatisfaction amongst the shareholders and a possible fall in the price of shares

Criticize these arguments

(49) In a manufacturing business, where the expenditure necessary to keep the works in proper order and efficiency varied very greatly from year to year, how could this expenditure be dealt with in the yearly accounts so that the profits available for dividend should not fluctuate greatly by reason of such expenditure being so variable?

(50) As auditor of a company you find that, during the year, large sums have been expended on repairs, renewals, alterations, and additions to plant and machinery How would you verify these payments, and by what principles would you be guided in deciding whether they were properly chargeable to capital or revenue?

(51) What are the various methods used in practice for writing off depreciation? Shortly describe each

(52) Write a short essay (not to *exceed* three sheets of foolscap) on "Secret reserves and an auditor's duty in connexion therewith"

(53) What are the provisions of the Companies Act, 1929, with reference to the appointment and remuneration of auditors?

(54) Set out the powers and duties of auditors under the Companies Act, 1929, and the directions contained therein with regard to the Auditor's Report

(55) Having completed the audit of a company's Balance Sheet, and having found everything in order, give a copy of your report to the shareholders in accordance with the Companies Act

(56) What are the requirements of the Companies Act, 1929, with reference to the Balance Sheet required to be filed with the Annual Return?

(57) A company registered under the Companies Act has issued shares for the purpose of raising money to defray the expenses of the construction of some works, which will not be able to earn income for two years The directors do not desire to charge interest on such shares to the Profit and Loss Account, but are of the opinion that it should be treated as capital expenditure What steps must the directors take to satisfy you, as auditor before you agree to certify the accounts without comment?

(58) What particulars have to be entered in a Register of Charges under the Companies Act?

(59) You are appointed auditor on the formation of a limited company, and are instructed to examine the books for the purpose of certifying the particulars required for the Statutory Report under the Companies Act What steps would you take to enable you to give the necessary certificate? Give the form of certificate

(60) When a company has not adopted a good system of account keeping, has an auditor any special duty to perform? Does the Companies Act confer any special power upon an auditor in this respect?

(61) Is an auditor entitled to examine the Minute Books of a company, and if so, for what reasons?

(62) Can Shares and Debentures be issued at a discount, and, if so, how should the discount be dealt with in the accounts?

(63) For what purposes should an auditor refer to the Memorandum and Articles of Association of a company?

(64) The directors of a company of which you are auditor, instruct you to audit once a fortnight the documents and entries in connexion with the transfer of the company's shares Set out fully what your duties are

(65) How should "forfeited" shares be treated in the published accounts of a company?

(66) What do you understand by "Debentures issued as collateral security for a Loan," and how should this position be shown in the Balance Sheet?

(67) What are the duties of an auditor of a company under the Companies Act in respect of the item "Preliminary and Formation Expenses" and how should the item be dealt with in the accounts of a company?

(68) A limited company was formed and incorporated on the 1st November, 1934, to acquire two private concerns as on the 30th June, 1934, adopting their trading from that date The purchases were completed on the 30th November, 1934 It was decided to keep the accounts of the two businesses separate until the 30th June, 1935 The net profits at that date were found to be £2100 and £3600 respectively for the year You are asked to advise the directors as to the amount of dividend they are justified, apart from financial considerations, in paying on the company's total capital of £50,000 in ordinary shares

What points for consideration would this involve?

(69) In auditing the accounts of a limited company, you find debited to the Profit and Loss Account, "Directors' Fees and their travelling expenses, £653 17s 6d" How would you satisfy yourself that this charge is correct?

(70) The directors of a company for which you are auditor consult you

with regard to the payment of an Interim Dividend State the points which would guide you in forming an opinion, and what information you would require before advising

(71) The Bulgarian Oil Company is a limited company, of which the capital is divided into Ordinary and Preference Shares the latter carrying a cumulative dividend of 6 per cent per annum For several years the company carried on business successfully and paid its Preference dividends and also considerable dividends to Ordinary shareholders At 30th June, 1934, it had an accumulative fund of undivided profits During the year ended 30th June, 1935, no profits were made and the accumulated fund was absorbed, leaving a small deficit, but this was not ascertained until the accounts were made up the following September On 1st July 1935 the directors paid to the Preference shareholders their usual dividend at the rate of 6 per cent per annum

Give your views as to the correctness or otherwise, of this action, and of the duty (if any) devolving on the auditor in connexion therewith

(72) With regard to Preference Shares, what is meant when they are 'Cumulative ' as to dividends? How should arrears of "Cumulative Preference dividend" be dealt with in the accounts of the company?

(73) How should unclaimed dividends be dealt with in the yearly Balance Sheets of a company?

(74) A limited company has a nominal capital of £50,000 in £1 Ordinary Shares

10,000 shares were allotted to the vendors as fully paid

35,000 shares were subscribed by the public and have been called up to the extent of 10s per share Of these, 400 shares, upon which 2s 6d per share only has been paid up, have been forfeited, and 400 shares have calls unpaid of 5s per share

State the capital of the company as it should appear in the published Balance Sheet

(75) The directors of a trading company present to their shareholders a Statement of Receipts and Payments only and, on the strength of a surplus shown on this statement, resolve to pay a dividend absorbing nearly the whole of the surplus Point out the risk they run of its being eventually declared that such dividend has not been earned and has therefore, been paid out of capital

(76) In the case of a newly formed company, set out in detail the extent to which you would check the issue of shares

(77) A company issues £40,000 debentures, such debentures being redeemable at the end of ten years at 105 It is decided to create a Sinking Fund to provide for the repayment of the debentures and the premium How should these transactions be dealt with in the accounts, and what will be the position at the end of the period when the debentures have been repaid?

(78) In what circumstances is it lawful for a company to pay commission to any person in consideration of his subscribing or procuring subscriptions for shares, and how should such payments be dealt with in the accounts?

(79) Is a company formed to work a wasting property bound to set apart a Sinking Fund to meet the depreciation of such property, and what is the legal position of an auditor of such a company in this connexion, and what are his duties?

(80) It is often stated that "Dividends have been paid out of Capital"

What is meant by this statement, and how can dividends be so paid out of capital?

(81) In the case of a manufacturing company, what is the legal position as regards the depreciation of plant and machinery?

(82) In the event of a company issuing shares at a premium, how should the premium be treated in the accounts, and is it available for dividend purposes?

(83) If there are not sufficient profits to pay the dividends on the Preference Shares, how should the arrears be dealt with in the accounts of a company?

(84) Is a company bound to replace lost capital out of revenue before it can declare dividends? State fully the reason for your answer

(85) If the directors of a company informed you that, owing to bad trade, they did not intend to draw their fees, what course would you adopt?

(86) The market value of the Investments of a trust company has fallen considerably, while the company has earned enough income to pay the usual dividend The directors ask you as auditor whether it will be in order for the dividend to be paid What advice would you give? State your reasons

(87) The directors of a company, limited by shares, have issued capital at a premium They are, under the constitution of the company, bound to provide for depreciation in respect of wasting assets out of revenue, and only entitled to declare dividends out of the profits of the company You are told that the Board have been advised that they cannot carry the premiums received to Revenue Account, and they have, therefore, decided to show the amount as a separate item on the debit side of the Balance Sheet, and apply one-tenth of it annually in aid of depreciation of leaseholds What is your duty as auditor in these circumstances? Give your reasons

(88) Are capital profits available for distribution as dividend? Give reasons for your answer

(89) Is an auditor personally liable if it is subsequently proved that the accounts he has certified are false or fraudulent?

(90) An engineering company has built a new workshop and equipped it with new lathes A portion of the work has been done by the company's own men, and a portion by outside contractors The addition has rendered it needful to provide increased steam power, and, consequently, an old engine has been sold and been replaced by a larger one purchased State what evidence you would require, as auditor, that the amounts charged to Buildings Account and Plant Account were correct, and how the cost of the additional steam power should be dealt with

(91) A limited company has removed its business to new works which have cost, including Freehold Land, £30,000 A portion of the machinery and plant, at an estimated value of £14,000, has been removed to the new works at a cost of £1800 The remainder has been sold, showing a loss on the total book value of the machinery and plant of £3200 The profits for the year, including the balance brought forward from the previous year, after making provision for the annual depreciation on the machinery and plant are £4500, without taking into account the above-named loss, and are about the normal profits in previous years

State your views as to the proper mode of dealing with the cost of removal and the loss on the sale, and whether, apart from financial considerations, the directors would be justified in declaring a dividend

(92) As regards the legal liabilities of auditors, is there any difference between the position of an auditor to a partnership, and an auditor appointed under the Companies Act?

(93) To what extent is an auditor responsible as regards the valuation of the Stock-in-Trade?

(94) The trading profits of a manufacturing concern for a year in which the sales have equalled the average of past years show a considerable reduction on preceding years You are asked to investigate and report to the partners the possible reasons for this reduction in profits

State what are the points to which you would give attention, and how you would proceed to investigate them

(95) In auditing the accounts of a charitable institution, where a paid secretary is employed, who is authorized to collect and give receipts for donations and subscriptions, what information and evidence would you require before certifying the Annual Accounts, to satisfy yourself that all the subscriptions and donations had been properly accounted for, and what safeguards would you suggest to ensure this?

(96) A company, desirous of extending its premises, obtains estimates for the work from builders the lowest of which is £4000 On consideration of the circumstances the directors of the company decide to carry out the work by means of their own staff, and the additional premises figure in their Balance Sheet at £4000, made up as follows—

	£
Net cost of materials purchased	1300
Discount thereon transferred to Interest and Discount Account	30
Labour on erection	2240
Managing director s supervision (part of his annual salary)	100
Proportion of office expenses	50
Interest on outlay to date of completion	40
Profit transferred to Profit and Loss Account	240
	£4000

What view should an auditor take of this transaction and of the various items involved?

(97) In examining a list of Debtors and Creditors with the Ledger Accounts for the purposes of a Balance Sheet, to what features of each account should you pay attention, apart from the mere arithmetical correctness of the extractions? Give examples of error or fraud which may be detected in this process

(98) Blank & Co keep all Bills Receivable in their hands until maturity, and then pay them into the Bank for collection On 31st July, when you are examining the Balance Sheet of 30th June, it appears that the actual bills in hand are in total £1000 less than the amount shown by the Ledger Account of Bills Receivable on 30th June, and it is explained to you that one of the bills then in hand (for £1000) has matured during July What entries would you expect to find in the July Cash Book as to this £1000, and to what examination would you subject them before concluding that the matter was in order?

(99) "In the case of a company, it is recommended that dividends should be debited to the Appropriation Account less Income Tax and not gross, and further the dividend recommended by the directors for declaration should be charged to the Appropriation Account and included amongst the current liabilities in the Balance Sheet"

Discuss this statement and express your views

(100) You are appointed auditor of a newly formed firm consisting of three partners, each of whom had previously carried on business as a sole trader The new partnership was constituted by the amalgamation of the three separate businesses

What information would you require before commencing the detail work of the audit?

(101) Write a report (limited to three sheets of foolscap) to Clients (a partnership) on the audit of any business with which you are acquainted, dealing with any difficulties you may have found in connexion therewith

(102) A B & C and D E & F are two firms of solicitors The former makes up its accounts on a cash basis, the latter brings in the estimated value of charges in respect of current matters

Amalgamation is to take place, A and D the senior partners, retiring Two questions are referred to you—

(*a*) B and C claim that in respect of the outstanding charges to be brought in Income Tax should be deducted from A's share on payment to him A disputes the deduction

(*b*) When D joined his firm he paid for his share on the basis of profits, which included outstanding charges at full charging-out price In later years the outstanding charges were taken on an increasingly conservative basis, and for five years past have been brought in less 50 per cent D claims his share of the full outstanding charges, E and F insist on the 50 per cent deduction

Give your decisions, with reasons

(103) Outline the chief points to be observed in carrying out the audit of the accounts of a retail trader who does a large counter and mail order business in addition to a certain amount of credit trade

(104) A company wrote off the balance of its Goodwill Account against a Reserve Account which had been built up out of profits Subsequently, losses were sustained which resulted in a considerable debit to Profit and Loss Account Later, profits were made, but these were insufficient to pay the dividend on the Preference Shares for the year and the arrears for two previous years The directors proposed to re-open the Goodwill Account and Credit the Appropriation Account with such an amount as would wipe out the debit balance on the Profit and Loss Account and would also provide an amount sufficient to pay the outstanding dividends on the Preference Shares

Were the directors in order in their proposals? Give reasons for your answer

(105) The statement given at top of page 329 is submitted to you for audit

In addition to the information given below your audit discloses that the society holds £1000 3½ per cent Conversion Loan (cost £980), that subscriptions for 1935 amounting to £17 17s have since been received and that £38 6s 9d was owing to the printers

Assuming that your detailed audit is satisfactory, would you be prepared to certify the statement as it stands? If not, redraft it in the form you would approve

(106) A client who intends to extend his business to transactions conducted on the Post Office C O D basis desires you to recommend to him a system of recording such transactions to safeguard him against fraud Give your recommendations

(107) In the course of your audit of the accounts of a limited company

THE BLANKSHIRE AGRICULTURAL SOCIETY BALANCE SHEET
For the year ended 31st December 1935

Receipts	£	s	d	*Expenditure*	£	s	d
To Balance at Bank	336	1	9	By Secretary's Salary	105	0	0
Subscriptions—				Advertising and Printing	269	16	9
1934	21	0	0	Postage and Incidentals	129	17	8
1935	875	0	0	Audit Fee 1934	5	5	0
1936	26	5	0	Expenses of Show	575	16	10
Donations to Prize Fund	210	0	0	Prizes	530	10	0
Entrance Money at Show	297	16	6	Placed on Deposit with Bankers	300	0	0
Rent of Show Space	205	0	0	Cash at Bankers	166	5	6
Advertisements in Catalogue	52	10	0				
Sale of Catalogues	23	18	6				
Interest on Investment and Bank Deposit	31	5	0				
Due to Secretary for Petty Cash	3	15	0				
	£2082	11	9		£2082	11	9

you find that the directors have charged considerable expenditure to Profit and Loss Account which appears to you to be in the nature of capital expenditure, and they do not disclose the fact in the published accounts or in their report to the shareholders

What steps would you, as auditor, take in the matter?

Give your reasons

(108) You are auditor of a private company in which there are only three shareholders, who are also directors In view of bad trade, efforts are made to reduce expenses in all possible directions You are asked to accept a reduced fee and are told that it is not necessary for you to do such a full audit as you have done in the past because the directors keep closely in touch with all the transactions

Give your views on this proposal and state your position, as auditor, should you adopt the suggestion of the directors

(109) When auditing the accounts of a company, you find that the investments are shown in the Balance Sheet at cost which is in excess of the present market value You desire that a note should be inserted stating the market value, but the directors object to this on the ground that the investments are redeemable securities and that the amount which will be received ultimately will be in excess of the cost price

Draft a letter to the directors embodying your views on this matter

(110) You are auditor of a dairy company which does a considerable business in articles which are not strictly in accord with the ordinary dairy trade, e g tea, jam, etc All these are purchased by the head office and distributed to the depots

You are asked to recommend a system of store records which would not only afford a check upon the head office storekeeper but also on the depot managers

Submit your recommendations

(111) A bank, having been asked by a commercial company to make an advance of £10,000, instructs you to investigate and to report upon the last Balance Sheet of the company, which was as follows—

BALANCE SHEET 31st December 1935

	£		£
Capital—		Goodwill at cost	16 000
Authorized and Issued 40 000 Ordinary Shares of £1 each fully paid	40 000	Plant and Machinery at cost (*less* depreciation)	19 570
Sundry Creditors	19 842	Leasehold Premises at cost 2nd Dec 1932	6 230
Bank overdraft	1 267	Sundry Debtors *less* Reserve for Bad Debts	7 984
Profit and Loss Account (balance)	647	Stock and Work in progress as certified by the Managing Director	6 648
There is a contingent liability of £350 in respect of bills discounted		Investments at cost (Deposited with the Bank as security for overdraft)	3 270
		Bill Receivable	1 240
		Cash in hand	814
	£61 756		£61 756

The books have been audited by a reputable firm, and your instructions are that it is not necessary to do any detail checking

Describe briefly the course of your investigation and draft your report to the bank

(112) Upon your appointment as auditor to a company, you are asked by the directors to advise them as to the basis upon which reserve for income tax should be made

The accounts of the company are made up to 31st December in each year, and you ascertain that income tax payable on 1st January in each year (less any recoveries of tax on payment of dividend) has been debited in the Profit and Loss Account for the preceding year The directors wish to avoid an undue burden of tax charge in any one year

Submit your reply and indicate to what extent, if at all, you would be prepared to meet the wish of the directors without qualification

(113) When examining the stock sheets of a manufacturing business, you notice three items which appear to you to be unusual, viz —

(i) Goods on consignment outwards—valued at market price to which 5 per cent has been added as representing a proportion of the profit which will be made when the goods are sold

(ii) Goods on consignment inwards—valued at invoice price

(iii) Goods sold but not delivered—valued at selling price

What special inquiries would you make in each of the three cases and, if you do not agree with the methods of treatment, how would you suggest that the items should be shown?

(114) On the formation of a company, a debt (amongst other assets) was taken over which was not then considered to be of any value Subsequently it was received in full, and, as no value had been placed upon it in the books of the company, the directors proposed to distribute the amount received to the shareholders as a dividend

Was it correct to do so, and should any other factors be considered before deciding whether the amount received was a profit divisible amongst the shareholders?

(115) The following Balance Sheet, submitted to you for audit, has been satisfactorily vouched If the form does not satisfy you, what amendment would you advise?

SWAN ALLEY LIMITED

BALANCE SHEET on 31st December 1935

Liabilities		£	*Assets*	£
Capital—			Cash	2 000
250 000 6 per cent Redeemable Preference Shares of £1 each	£250 000		Sundry Debtors	250 000
550 000 Ordinary Shares of £1 each *less* calls in arrear	£500 000		Loans to Directors	19 000
		750 000	Stock in Trade	100 000
6 per cent Debenture Stock		700 000	Work in Progress	450 000
Bank Overdraft		50 000	Investments— Subsidiary Companies *less* amounts owing	300 000
Creditors and Credit Balances		600 000	Buildings Plant and Goodwill etc	1 000 000
Sundry Liabilities		12 000	Preliminary Expenses and Discount on Debentures	75 000
Profit and Loss Account		75 000		
		£2 187 000		£2 187 000

(Signed) S ALLEY *Director*

(116) It frequently happens that the greater part of the subscribed capital of limited companies is invested in stocks and shares of other companies What are the principles on which the following are determined?

(*a*) The necessity for writing off depreciation

(*b*) The amount of the depreciation to be written off

(*c*) The assessment of profits to income tax

(117) When examining the stock sheets of a foundry in which fire grates and stoves are manufactured you find the following items—

		£
100 tons Pig Iron	42s	220
60 Moulding Boxes	30s	90
500 Patterns—materials + (labour + 100 per cent)		2500
10 Stoves on Sale or Return	120s	60
5000 Catalogues		200
60 Stoves partly completed	60s	180
Office safe		45
		£3295

What action would you take in respect of each item?

(118) Briefly comment on the following matters which come before your notice during the audit of a company's accounts—

(*a*) The Articles of Association provide "Any voucher signed by two directors shall be evidence of a payment chargeable against the company and shall be accepted by the auditors as such"

(*b*) The directors hand you a list of the work they intend you to do for a fixed fee, stating they will be satisfied if it is carried out

(*c*) The Minute Book is in the form of a loose leaf book, the chairman signing the last page of the minutes of each meeting

(*d*) At one meeting when a proposal to buy another business for cash was approved, and in fact carried out, a quorum was not present but this had been overlooked,

(*e*) The managing director was entitled to a large salary but in order to convert a loss into a small profit he had drawn and charged in the Accounts only one-half of the sum to which he was entitled

(119) Amongst the assets of a private limited company is a house in which the managing director is allowed to live rent free The company's accounts submitted to you for audit contain the following charges against profits—

	£	s	d
Painting and Redecorating Drawing room	10	7	6
Repainting exterior of House	48	9	0
New Fireplace and Mantelpiece in Dining room	35	15	0
Planting 6 Apple Trees in Garden	5	16	0
Laying down Hard Tennis Court	205	0	0

All the orders had been given on the company's form

What would you, as auditor, do in regard to these items?

(120) You are appointed auditor to a company the last Balance Sheet of which disclosed an asset described as "Leasehold Premises at cost less amounts written off—£15,000"

Upon investigation you discover the following—

(*a*) The lease of the premises was purchased ten years previously for £17,500

(*b*) There is, at the date of your audit an unexpired period of forty years

(*c*) Shortly after the purchase of the lease, £5000 was expended on buildings and was added to the original cost

(*d*) Various sums had been written off when there were surplus profits, reducing the book value to its present figure of £15 000

(*e*) The secretary of the company holds a letter of recent date from a well-known firm of estate agents to the effect that, in their opinion, the realizable value of the property is £18 000

You are informed that the directors of the company are not in agreement as to the method to be adopted and you are asked to submit your views on the following proposals—

(i) That such sums as are not required for dividend purposes, etc, should, from time to time, be used to reduce the book value of the lease

(ii) That as the realizable value of the lease is in excess of the book value, there is no necessity to write off anything

(iii) That the book value of the lease be written off by equal annual instalments over the unexpired period of the lease

Submit your views on each of the above proposals in the form of a report to the directors, stating which you prefer and why

(121) What are the advantages and disadvantages, from an auditor's point of view, of book-keeping by accounting machines?

(122) It is suggested that H M Customs and Excise provide an opportunity for misappropriation on the part of fraudulent cashiers in that the new tariff schedules are so long and complicated that many cases arise where import duty cannot be immediately assessed In such cases, it is possible to obtain goods out of bond by tendering the maximum possible duty, pending agreement as to the actual duty payable If duty has been overpaid, a refund is made by draft, but surrender of the original receipt for duty is not required

What precautions should you, as auditor, take to safeguard against the misappropriation of any sums returned?

(123) On 31st December, 1934, the directors of a company holding a large number of investments which appeared in the Balance Sheet at cost (which was considerably in excess of the then market value) inserted a note of the market value

During the year 1935 some of the investments were sold at a substantial profit, some part of which was used to write down the book values of investments still held which were above market values as on 31st December, 1935 The remaining investments stood in the books at a figure below market value These the directors decided to write up to market values and to credit a Contingencies Reserve, to which account was credited also the balance of profit on sale of investments

When the accounts to 31st December 1935, were prepared, it was found that the available profit was some thousands of pounds short of the amount required to meet the dividend the directors wished to recommend They therefore transferred to Profit and Loss Account the whole of the Contingencies Reserve, stating the figure as a special item in the Profit and Loss Account

Do you approve of this course? If not, write a letter to the directors giving your reasons for your disapproval and stating what you consider would be the correct method of dealing with the matter

(124) A colonial wine company were importers and bottlers In order to popularize a particular brand of wine, an arrangement was made by which purchasers of the wine, on presentation of a dozen capsules, of which one is attached to each bottle, might obtain a "free" bottle with the usual gift capsule attached

In the Balance Sheet as on 31st March, 1936, which you are auditing, there appears a reserve of £7500 against the liability under the scheme The directors inform you that this reserve is based upon the number of capsules estimated as likely to be presented and calculated at a cost of 5s per dozen capsules, of which 4s 9d is the retail price per bottle of wine and 3d for redemption department expenses

The total number of bottles of the particular brand sold since the beginning of the scheme was 920,000 and the total number of "free" bottles issued was 40,000

Do you consider the basis upon which the directors have formed the reserve is correct? If not, suggest an amendment and state what further information you would require before reaching a conclusion as to the adequacy of the reserve

(125) Explain carefully the methods, usually adopted by companies keeping their accounts under the double account system, of treating the scrapping of an asset and its replacement on a larger scale or by an asset containing some element of betterment

(126) The following items appear in the Cash Book of Z Limited—

(*a*) £650 paid as a first premium under an insurance policy taken out for the purpose of providing for the renewal of a lease of the company's premises

(*b*) £1000 paid by way of bonus to the managing director

(*c*) £250 paid to each of four directors to cover travelling and entertainment expenses incurred by them during the preceding year on the company's behalf This is the first time such a payment has been made by the company

(*d*) £2000 paid to an ex-employee who threatened to bring an action for wrongful dismissal

(*e*) £10,000 received from one of the directors as an unsecured loan to carry interest at 10 per cent per annum

(*f*) £5000 advanced to another director to carry interest at 1 per cent over bank rate

(*g*) £1550 paid to the X Bank Ltd in fulfilment of a guarantee given by the company of an overdraft granted by the bank to Y Ltd, now insolvent Y Ltd were previously large customers of Z Ltd

State how you would vouch each of these items, and whether, in your opinion, any of them would call for further, and if so what, action on your part

(127) A B is in business as a manufacturing confectioner His accounts have not been audited, but he has recently found out that extensive defalcations have been practised by members of his staff

Typical examples of these defalcations are as follows—

(*a*) Z, the sales ledger clerk, had a retail shop carried on under his wife's maiden name Orders sent to A B for goods were, at first, paid for regularly Subsequently, cash was credited to the account, although in fact none had been received To keep the Sales Ledger in balance, a corresponding amount was debited to another customer s account and transferred to a third and fourth account as required (under a later date in each case) so that no account appeared to be overdue

(*b*) The balance shown by the Petty Cash Book was £80 The actual balance was only £5

(*c*) Petty cash vouchers had been altered to amounts larger than those actually paid, the differences being appropriated by the petty cashier

(*d*) The manager had been remunerated partly by a commission on the profits shown by the annual accounts These had been inflated by the inclusion in the Sales Day Book of goods sold which in fact had not been sold until early in the next period The dates on the duplicate copies of the invoices had been altered to the last day of the previous accounting period

(*e*) Two employees had been discharged three months before the end of the year, but the wages clerk had continued to draw the salaries for them each week, which he had appropriated

(*f*) Goods lost in transit had been the subject of claims on railway companies which had been duly settled The cashier had misappropriated the sums received and the claims had been written off

A B asks whether an annual audit would have disclosed defalcations such as these

Submit your reply and indicate the means by which the defalcations might have been brought to light in an audit

(128) By the will of a testator, who held a controlling interest in a private limited company, the executors are directed to offer within one year of death the shares held by the testator in that company to certain named persons at a price to be fixed by the auditors to the company

What facts should be taken into account in fixing the price of the shares?

(129) How could frauds be perpetrated through the Bought Ledger? State against each example what audit steps you would take to ascertain whether, in fact, fraud had taken place

(130) During the course of the audit of a company's accounts you require verification from the company's bank of various items appearing on the Balance Sheet

Draft a letter to the bank covering the matters you would expect them to be able to verify

(131) In connexion with the valuation of the process and completely manufactured stocks of a manufacturer, the works oncost charges may be

provided for in the valuation by means of a percentage added to the direct labour cost The percentage used for this purpose is sometimes the percentage for the last quarter of the year the percentage at the time the goods were manufactured, the average percentage for the year, or the standard percentage based on a normal volume of production

Discuss these various bases and describe their effect and state which basis you would recommend, giving your reasons

(132) There are five directors of a company—A, B, C, D and E—each of whom receives director s fees of £200 per annum A is chairman for which he receives an additional fee of £300 per annum B is managing-director for which he receives an additional remuneration of £1000 per annum C is secretary for which he receives a salary of £500 per annum D and E each receives a director's fee from a subsidiary company of £200 per annum, and £100 per annum each from a subsidiary of the subsidiary company

State how the above payments should be shown in the Profit and Loss Account of the company, giving figures and explaining how they are arrived at

(133) When auditing the accounts of a limited company you find that the following transactions effected during the company's financial year have not been taken into consideration in the Balance Sheet submitted to you—

(*a*) Bills receivable for £5000, due after the end of the financial year, discounted with the company's bankers

(*b*) Shares purchased, costing £1500, the settlement for which was not due until five days after the close of the financial year

(*c*) Contracts for the supply of raw materials, entered into in the ordinary course of business, continuing for periods ranging from six to twelve months after the end of the company's financial year

How do you suggest that these transactions should be dealt with in the published accounts?

(134) The accounts of a limited company show that for the past two years the income tax deducted from dividends paid exceeded the company's liability for income tax in those years There is thus a credit balance on "Reserve for Income Tax Account" in excess of the company's tax liability for the year The directors, when considering the annual accounts, propose to transfer this excess to the credit of Profit and Loss Account in order to increase the profit to a figure sufficient to continue to pay a dividend on the Preference Share capital

What are your views on this proposal and what action would you take as auditor?

(135) The basis of inventory valuation is the lower of cost or market values By market value do you understand replacement value or realizable value? Give your reasons

(136) In the case of a holding company, upon what principles should the shareholdings in subsidiary companies be valued and how should these investments and also loans to and from subsidiary companies be stated in the holding company's Balance Sheet?

(137) A Ltd is a holding company controlling B Ltd, which in turn controls C Ltd Certain further shares in B Ltd are offered to A Ltd, which has no funds available, but B Ltd has ample resources Accordingly B Ltd lends to C Ltd sufficient cash to acquire the shares, which sum C Ltd then lends to A Ltd With the proceeds A Ltd buys the

shares Is this in order, or would you, as auditor of all the companies, qualify your certificates in respect of the transactions?

(138) In view of the different methods adopted by companies in incorporating in their Profit and Loss Accounts the profits (or part of them) and the losses, of their subsidiaries, and also the manner of showing in their Balance Sheets the amount of profits so included but not paid over, how would you advise that they be shown?

Give your reply in the form of a report to the directors of a company of which you are the auditor, setting out alternative methods and supporting your opinion of the method you prefer by reference, so far as you think it applies, to the Companies Act, 1929

(139) "The holding company type of organization is capable of being improperly used as a cloak to hide from shareholders the true position of the combine in which they are interested" Discuss this statement and state your views

(140) In the case of a holding company how should the following transactions be dealt with in the accounts of the holding company—

(a) A dividend received by the holding company and paid out of undistributed profits of a subsidiary and which profits were in existence at the time when the holding company purchased its shares in the subsidiary

(b) Inter-company profits in the stock valuations of subsidiaries

(c) A bonus received from a subsidiary and paid out of a General Reserve accumulated since the holding company acquired its shares in the subsidiary

(141) If the Board of a holding company decides to issue Consolidated Statements, what, in your opinion, would be the factors governing the point of consolidation, i e the Subsidiary and Associated Companies Accounts that would and would not be consolidated?

(142) What, in your opinion, are the chief advantages to shareholders of a holding company publishing Consolidated Statements of Earnings and Assets and Liabilities?

(143) When preparing a Consolidated Statement of Assets and Liabilities of a holding company, how should the interest of outside shareholders be adjusted for?

(144) A holding company purchased for £400,000 the whole of the issued share capital of another company whose Balance Sheet was as follows—

	£		£
Share Capital 300,000 shares of £1	300 000	Goodwill	75 000
Current Liabilities	95 000	Fixed Assets	170 000
Profit and Loss Account	45 000	Current Assets	195 000
	£440 000		£440 000

Assume that the purchase was effected on the day that the holding company closed its accounts and therefore that the above balance sheet has to be consolidated Describe exactly what figures would be included in the Consolidated Statement of Assets and Liabilities, and under what headings?

(145) The aggregate losses of a 100 per cent subsidiary amounted at the 31st December, 1933, to £15,000 at which date a corresponding reserve had been made in the holding company's accounts In 1934 the

subsidiary made a profit of £5000 The directors of the holding company decide to reduce the reserve for losses of subsidiaries by £5000 and to credit Profit and Loss Account As auditor what would your views be?

(146) As auditor of a holding company you observe that a note appears upon the Balance Sheet of a 100 per cent subsidiary company to the effect that there is a contingent liability of £50,000 in respect of a claim for damages which is in dispute What action would you take?

(147) In the case of a holding company in a particular year certain 100 per cent subsidiaries incurred losses aggregating to £17 000, on the other hand other 100 per cent subsidiaries made profits aggregating to £120,000 of which £100,000 was distributed as dividends to the holding company and taken credit for in its accounts The directors contend that there is no need to provide for the losses of £17,000, as these losses are more than offset by the undistributed profits of £20,000 As auditor what would your advice be? Give your reasons

(148) Assume that in a year certain subsidiaries have incurred losses material in amount and in the accounts of the holding company provision has not been made for the holding company's proportion of such losses In the directors' statement on the Balance Sheet it is stated that provision has not been made for these losses, although no amounts are given What action would you as auditor take? Give your reasons

(149) A holding company, of which you are auditor, has guaranteed as regards dividends and principal the preference share capital of a subsidiary What points arise in connexion with the holding company's accounts?

(150) As auditor of a holding company, for what purposes would you require to examine the accounts of subsidiary and sub-subsidiary companies?

APPENDIX C

(Reprinted from *The Accountant*)

ACCOUNTING PRINCIPLES

THE RECOMMENDATIONS OF THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

THE Council of the Institute of Chartered Accountants makes the following recommendations to its members on certain aspects of the accounts of companies engaged in industrial and commercial enterprises Whilst it is recognised that the form in which accounts are submitted to shareholders is (subject to compliance with the Companies Act) a matter within the discretion of directors it is hoped that these recommendations will be helpful to members in advising in appropriate cases, as to what is regarded as the best practice

I TAX RESERVE CERTIFICATES

It is considered that regard should be had to the relevant conditions of issue set forth in the leaflet issued by the Treasury on 22nd December 1941 namely—

(*a*) Certificates can be used for the payment of income tax (except under Schedule E) sur tax national defence contribution excess profits tax and war damage contributions under Part I of the 1941 Act but this right is limited to such liabilities falling due not less than two months and not more than two years from the date of the certificate if so used interest is allowed at 1 per cent per annum free of tax

(*b*) They are not transferable (except under the ordinary law on death bankruptcy etc) and consequently cannot be pledged as security

(*c*) They may be surrendered after two months against a cash payment but no interest is then allowable

(*d*) The appropriation of the amount represented by the certificate for any of the liabilities referred to in (*a*) above or the surrender against a cash payment is at the option of the holder

Recommendation

It is therefore recommended that—

(1) The amount of tax reserve certificates held should be shown as a separate item in the balance sheet and grouped with the current assets

(2) The 1 per cent per annum allowed on the surrender of the certificates in payment of taxation etc , should be treated as interest and not as a reduction of the taxation charge

Note —It is suggested that accrued interest to the date of the balance sheet should not be taken to credit unless the certificates have been surrendered before the balance sheet has been signed

II WAR DAMAGE CONTRIBUTIONS, PREMIUMS, AND CLAIMS

War Damage Contributions

(*a*) The War Damage Act, 1941, enacts that contributions under Part I (Properties) shall be treated for all purposes as outgoings of a capital nature

(*b*) The liability under Part I is referred to as 'the contribution and is payable by five annual instalments, the first of which was due on 1st July, 1941 The risk period under the Act of 1941 covered by this contribution extended from 3rd September, 1939, to 31st August 1941

(*c*) Under the War Damage (Amendment) Act 1942, the risk period covered by the contribution was extended for all purposes to 31st August 1942 and thereafter until terminated by an order made by the Treasury and approved by a resolution of the House of Commons

(*d*) It has been the general practice on the ground of financial prudence to make provision for the full contribution out of available profits or free reserves

Recommendation

Bearing in mind that (i) payment of the contribution adds nothing to the asset values and (ii) notwithstanding (*a*) above, it is open to directors to achieve the same

result by appropriating profits to a reserve equivalent in amount to the contribution if treated as capital the general practice referred to in (*d*) above is recommended But whatever course is adopted the annual accounts should show the facts in order that they may be before the shareholders when approving the accounts

In cases where the full contribution for the cover has been provided to 31st August 1942, no provision is considered to be necessary in respect of possible contributions for subsequent periods

War Damage Premiums

The War Damage Act 1941 enacts that premiums under Part II (Plant Equipment etc) shall similarly be treated as outgoings of a capital nature

Recommendation

For the same reasons as in the case of Part I and particularly as premiums under Part II cover a risk for a definite period under the terms of a policy it is recommended that in whatever manner the contribution under Part I may have been treated the premiums under Part II should be provided out of available profits or free reserves by reference to the period covered

Note —The recommendations made above regarding contributions and premiums may not be appropriate to certain classes of companies such as statutory companies property companies and building societies or where property is held for sale

War Damage Claims—Fixed Assets

The treatment in published accounts of war damage claims on fixed assets is already fully covered by a circular letter issued to professional firms on behalf of the Council by the Secretary of the Institute dated 20th August 1941 It has, however transpired that many industrial accountants are not aware of the Council s recommendations in this connection and accordingly it is considered desirable to include the following extracts from the letter referred to—

The Ministry of Information have in a considerable number of cases approved the use of the following alternative forms of wording which have been agreed with groups of accountants as a note on balance sheets of companies whose assets have suffered from war damage with a view to the avoidance of qualifications in the auditors report—

(*a*) Owing to the war, adjustments will be required at a future date in respect of certain of the assets included in the above account

(*b*) Adjustments are required to certain assets which will be dealt with when the position is fully ascertained

The Council have had these suggested wordings under consideration, and I am instructed to advise you that whilst in many cases the forms of wording might be appropriate the Council feel that standard forms of qualifications tend to become restrictive and might not be appropriate in all cases Every case must be considered on its merits, including the question as to whether the company is a subsidiary where a qualification in an auditors report might possibly be unavoidable

It is understood that the Ministry of Information has no desire to standardize any particular form or forms of words Its sole concern is to advise whether the accounts as presented contain information which might be useful to the enemy Every case in which accounts are submitted to the Ministry will be considered with a view to allowing the maximum information compatible with safety to be published In general, the extent to which particulars of damage can be stated will depend largely on the importance of the particular company to the country s war effort

III THE TREATMENT OF TAXATION IN ACCOUNTS

The incidence of taxation and its effect on profits and on the financial position disclosed by the Balance Sheet together with the extent to which the Inland Revenue on the one hand and shareholders on the other have participated in profits are matters which should be made clear to shareholders

The assessment of both national defence contribution and excess profits tax is based on the profits of the accounting period under review The assessment of liability to income tax is however for the fiscal year ending 5th April and is normally based on the profits of a preceding accounting period The minimum or legal amount to be provided for taxation is thus the aggregate of taxes assessable on these bases apportioned as regards income tax according to the period covered by the accounts under review

Income tax so apportioned takes no account however either of the balance of the liability assessable for the current fiscal year or of the liability which in normal

circumstances will arise in respect of profits included in the accounts but not assessable until the following fiscal year Further unless provision be made year by year for income tax based on each year s results the trend of net available profits will not be apparent and cases will arise where the profits earned in a succeeding period will bear a disproportionate charge for taxation—indeed they may even be insufficient to meet it

In the case of principal and subsidiary companies (as defined in the Finance (No 2) Act 1939) excess profits tax is assessable on the principal company in respect of the net excess profits of the group The principal company has however the option of recovering from any subsidiary the tax charge relative to the excess profits of such subsidiary or of crediting any subsidiary with the tax benefit arising from the deficiencies of such subsidiary The charge for taxation in the principal company s accounts thus depends upon the exercise (in whole or in part) of the option to allocate excess profits tax over subsidiaries and may not be appropriate to the profits shown in the principal company s own accounts

Recommendation

It is therefore recommended that—

(1) The charge for income tax should be stated in the accounts and subject to war time or other special circumstances the charge for national defence contribution or excess profits tax should also be stated

(2) (*a*) The charge for income tax should be based on the profits earned during the period covered by the accounts

(*b*) Where it has been the practice to charge only the minimum or legal liability then until full provision has been made for income tax on all profits up to the date of the Balance Sheet it is desirable where possible to make provision in addition for or towards the balance of the liability for the current and following fiscal years This provision should be shown separately in the Profit and Loss Account

(*c*) Whatever method is adopted the bases (i) of the charge and (ii) of any supplemental provision made for income tax should be disclosed

(*d*) Income tax on revenue taxed before receipt should be included as part of the taxation charge for the year and the relative income should be brought to credit gross

(3) In the case of principal companies it should be indicated whether the provision for excess profits tax is in respect of the group or whether the sum charged has been arrived at after taking into account amounts allocated over subsidiary companies

(4) Taxation charges may be affected by losses in the current period deficiencies brought forward or adjustments of taxation in respect of previous periods the effect of which if material should be disclosed Any provision made in excess of the amount required to cover the estimated future liability on profits earned to date should if material be similarly disclosed

(5) Any provision for (or in excess of) the estimated future liability to income tax in respect of the fiscal year commencing after the date of the Balance Sheet should not be included with current liabilities but should be grouped with reserves or separately stated as a deferred liability and suitably described

IV THE TREATMENT IN ACCOUNTS OF INCOME TAX DEDUCTIBLE FROM DIVIDENDS PAYABLE AND ANNUAL CHARGES

The payment of a dividend to shareholders does not affect the amount of tax payable by a company, the assessment being on the amount of the profits as adjusted for the purposes of income tax

On the other hand income tax deducted upon payment of debenture and other interest royalties and similar annual charges is in effect assessed on a company for collection from the payee

Recommendation

It is therefore recommended that—

(1) (*a*) Whether dividends are described "less income tax or free of income tax ' the amounts shown in respect thereof in the accounts should be the net amounts payable

(*b*) Where a company continues the practice of providing for dividends gross the narrative should indicate that the distributions are subject to income tax The taxation charge should be arrived at after taking credit for the tax deductible on payment of the proposed dividends

(2) Annual charges for debenture and other interest royalties and similar annual payments should be charged gross

V THE INCLUSION IN ACCOUNTS OF PROPOSED PROFIT APPROPRIATIONS

Although certain appropriations of profits including dividends recommended by directors are subject to subsequent confirmation by shareholders the inclusion of all appropriations in the accounts shows the amount which will be required for distribution to the shareholders and completes the accounts for the financial year by showing the results of trading and their application in one account This course avoids the inclusion in the accounts of the next period of appropriations which were set out in the directors report for the previous period and have already been dealt with and disposed of Also it facilitates the linking up of the accounts from one period to another the balance carried forward to the following period being clearly shown in the accounts of each year

Recommendation

It is therefore recommended that—

Provision be made in the books and in the Annual Accounts for proposed profit appropriations those subject to confirmation by shareholders being so described. Provision for dividends should be shown as a separate item in the Balance Sheet

VI RESERVES AND PROVISIONS

A true appreciation of the financial position of a company as disclosed by its Balance Sheet may be rendered difficult or even impossible owing to lack of information as to the extent of undisclosed reserves and to insufficient distinction being made between (*a*) free reserves retained to strengthen the financial position or to meet unknown contingencies (*b*) capital reserves or other reserves not normally regarded as available for distribution as dividend (*c*) provisions for known contingencies and (*d*) provisions for diminution in value of assets in excess of normal or estimated requirements

The terms ' reserves and provisions' are commonly regarded as interchangeable Accounts would be more clearly understood if the term reserve were applied only to reserves which are free and the term provision were confined to amounts set aside for specific requirements

Unless the amounts involved are stated the trend of profits may be obscured by transferring amounts to or from undisclosed accounts of the nature of free reserves by charging abnormal provisions or by utilizing provisions no longer required

Recommendation

It is therefore recommended that—

(1) The following distinction should be made between reserves which are free and those in the nature of provisions for specific requirements the latter should preferably be described as 'Provisions"—

- (*a*) The term reserve should be used to denote amounts set aside out of profits and other surpluses which are not designed to meet any liability contingency commitment or diminution in value of assets known to exist as at the date of the Balance Sheet
- (*b*) The term ' provision' should be used to denote amounts set aside out of profits or other surpluses to meet—
  - (i) specific requirements the amounts whereof can be estimated closely and
  - (ii) specific commitments known contingencies and diminutions in values of assets existing as at the date of the Balance Sheet where the amounts involved cannot be determined with substantial accuracy

(2) Reserves as defined in (1) (*a*) above, should be disclosed in the Balance Sheet

The term "Reserve Fund should only be used where a reserve is specifically represented by readily realizable and earmarked assets

Where two or more reserves are retentions of distributable profits available for general use in the business and none of them is created in accordance with statutory requirements or in pursuance of any obligation or policy, the subdivision of such reserves under a variety of headings is unnecessary Capital and other reserves not normally regarded as available for distribution as dividend should, however, be separated from those of a revenue nature the latter group to include any undistributed balance or by deduction, any adverse balance on Profit and Loss Account

(3) As a general principle 'Provisions, as defined under (1) (*b*) (ii) should be disclosed in the Balance Sheet under one or more appropriate headings Only in

circumstances where disclosure of the amount of a particular provision would clearly be detrimental to the interests of a company should it be included under another heading for example Creditors the fact that such heading includes Provisions should then be indicated in the narrative

Where practicable fixed assets in existence at the date of the Balance Sheet should be shown at cost and provisions for depreciation and for diminution in values should appear as separate deductions therefrom

(4) Subject as in (3) above in regard to provisions the disclosure of which would be detrimental to the interests of a company where reserves and provisions are created or increased the amounts involved if material and the sources from which they have been created or increased should be disclosed in the accounts In all cases the utilization of reserves and of provisions proved to have been redundant should be disclosed in the accounts

VII DISCLOSURE OF THE FINANCIAL POSITION AND RESULTS OF SUBSIDIARY COMPANIES IN THE ACCOUNTS OF HOLDING COMPANIES

Where a company holds a direct or indirect controlling interest in another company or companies (referred to in this memorandum as subsidiary undertakings) a true appreciation of the financial position and the trend of results of the group as a whole can be made only if the accounts of the holding company as a separate legal entity take into account or are supplemented by information as to the financial position and results of the subsidiary undertakings

The following are three methods of disclosing this supplemental information Each has its own value and limitations The first and second methods are suitable only in special cases

Method (1) To submit copies of the accounts of each of the subsidiary undertakings

This method is suitable only where it is desired to focus attention on the financial position and earnings of each component of the group It is impracticable where the companies are numerous and in all but the simplest cases the shareholders of the holding company could not obtain a true view of the group as a whole without considerable explanation of inter company relations

Method (2) To submit statements of the consolidated assets and liabilities and of the aggregate earnings of the subsidiary undertakings as distinct from those of the holding company

This method is of value where it is desired to show the underlying assets which represent the investment of the holding company in its subsidiary undertakings or particular groups of them and also the earnings attributable thereto

Note —As regards methods (1) and (2) if the holding company trades extensively with or through its subsidiary undertakings the disclosed earnings of the subsidiary undertakings may not by themselves be a true criterion of the real value of the holding company s interests in such undertakings in such circumstances their value cannot be assessed separately from the value of the group undertaking as a whole

Method (3) To submit a Consolidated Balance Sheet and a Consolidated Profit and Loss Account of the holding company and of its subsidiary undertakings treated as one group

This method is the most suitable for general application

It must however be remembered that a Consolidated Balance Sheet is not a record of the assets and liabilities of a legal entity and that the liabilities of each company in the group are payable only out of its own assets and not out of the combined assets of the group Also there may be special cases where it may be impracticable or inappropriate to include the figures of a particular subsidiary undertaking in the consolidation This applies especially in the case of subsidiary undertakings operating overseas where apart from the temporary difficulty of enemy occupation there may be restrictions on exchange

A Consolidated Profit and Loss Account does not suffer to the same extent from these limitations and subject to any necessary explanations the aggregate results of the group as a whole can be stated Such disclosure is important even if for any reason the publication of a complete Consolidated Balance Sheet is impracticable or inappropriate

Recommendation

It is therefore recommended that in the case of every holding company—

(1) With the published accounts statements should be submitted in the form of a Consolidated Balance Sheet and Consolidated Profit and Loss Account or in such

other form as will enable the shareholders to obtain a clear view of the financial position and earnings of the group as a whole

(2) Every consolidated statement should indicate—

(a) The nature and measure of control adopted as a basis for the inclusion of subsidiary undertakings

(b) The reasons for the non inclusion of any subsidiary undertakings which would normally be included on the basis adopted for the group

(c) The procedure adopted in cases where the accounts of subsidiary undertakings are not made up to the same date as the accounts of the holding company

(d) In the case of subsidiary companies operating overseas if relatively important the basis taken for the conversion of foreign currencies as affecting assets liabilities and earnings

(3) The Consolidated Balance Sheet should exclude inter company items and should show the combined resources of the group and its liabilities and assets aggregated under suitable headings It should distinguish between capital reserves not normally regarded as available for distribution and revenue reserves, including those which would be available for distribution as dividend by the holding company if brought into its accounts It should also show the interests of outside shareholders in the capital and reserves of the subsidiary undertakings and under a separate heading the interests of the group in subsidiary undertakings which have not been consolidated

(4) The Consolidated Profit and Loss Account or other information given as to the earnings of the group should disclose the aggregate results of the group for the period covered by the accounts after eliminating the effect of inter company transactions It should be in such a form that these aggregate results may readily be reconciled with those shown by the Profit and Loss Account of the holding company in which should be stated separately the aggregate amount included in respect of subsidiary undertakings whose accounts have not been consolidated

The following *inter alia* should be separately stated—

(a) The aggregate results of any subsidiary undertakings the Balance Sheets of which have not been included in the consolidation

(b) The portion of the aggregate net results attributable to outside shareholders interests in the subsidiary undertakings

(c) The portion of the consolidated net results attributable to the holding company's interest which remains in the accounts of consolidated subsidiary undertakings or the amount by which the dividends from such subsidiary undertakings exceed the holding company's share of their earnings for the period

(5) Profits earned and losses incurred by subsidiary undertakings prior to the acquisition by the holding company of the shares to which they are attributable should be viewed as being of a capital nature from the standpoint of the holding company Such pre acquisition profits (whether received in dividend or not) should therefore not be brought into account as being available for distribution in dividend by the holding company

VIII FORM OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

Businesses are so varied in their nature that there must be flexibility in the manner of presenting accounts and a standard form to suit every commercial and industrial undertaking is neither practicable nor desirable The financial position can however be more readily appreciated if the various items in the Balance Sheet are grouped under appropriate headings and a proper view of the trend of the results can be obtained only if certain principles are consistently applied and if profits or losses of an exceptional nature or relating to previous periods are stated separately in the Profit and Loss Account In both cases appreciation is facilitated if the comparative figures of the previous period are also given

Recommendation

It is therefore recommended that subject to compliance with statutory requirements the Balance Sheet and Profit and Loss Account should be presented in conformity with the following general principles—

BALANCE SHEET

The use of general headings for a Balance Sheet such as "Liabilities" and "Assets," is inappropriate and unnecessary The various items whatever may be their sequence or designation should however be grouped as indicated below under appropriate headings Additional groups may be necessary in certain cases to

show the aggregate liabilities and assets subject to exchange or other restrictions special funds and other special items such as deferred revenue expenditure Where any material part of a company s liabilities or assets is in foreign currency, the basis of conversion to sterling should be disclosed

Share Capital

In addition to the authorized and issued amounts of the various classes of capital and the redemption date of any redeemable preference capital the terms of redemption should be stated Particulars of any option on unissued capital should also be given If dividends on cumulative preference capital are in arrear the gross amounts of dividends in arrear or the date up to which the dividends have been paid should be stated

Reserves

The items to be included in this group are amounts set aside out of profits and other surpluses which are not designed to meet any liability contingency commitment or diminution in value of assets known to exist as at the date of the Balance Sheet Capital and other reserves not normally regarded as available for distribution as dividend should be shown separately from those of a revenue nature the latter group to include any undistributed balance or by deduction any adverse balance on Profit and Loss Account

A sub total of share capital and reserves should be given to indicate the members interest in the company

Debentures, Mortgages and Long term Liabilities

In this group should be included debentures, mortgages and other long term loans or liabilities Where practicable the dates and terms of redemption should be stated

The expression long term is intended to cover liabilities not due for payment until after the lapse of one year from the date of the Balance Sheet

Amounts Owing to Subsidiary Undertakings

In addition to the aggregate amount owing to subsidiary companies the aggregate amount owing to sub subsidiary companies should be disclosed Such aggregate amounts may be shown under long term liabilities current liabilities or as a separate group according to their nature

Current Liabilities and Provisions

The items in this group should be classified to disclose their nature and amount including, *inter alia*, (*a*) trade liabilities bills payable and accrued charges (*b*) bank loans and overdrafts (*c*) other short term loans, (*d*) interest accrued on debentures and long term liabilities (*e*) provision for current taxation (see Recommendation No III) (*f*) provisions to meet specific commitments or contingencies where the amounts involved cannot be determined with substantial accuracy (see Recommendation No VI) and (*g*) provision for proposed dividends

Commitments for Capital Expenditure

Where commitments of material amount for capital expenditure exist at the date of the Balance Sheet these should be indicated in a suitable note

Contingent Liabilities

Contingencies on guarantees, bills under discount partly paid shares and similar items should be dealt with by note

Fixed Assets

In this group should be shown under separate headings fixed assets such as (*a*) goodwill, patents and trade marks (*b*) freehold land and buildings (*c*) leaseholds (*d*) plant, machinery and equipment, (*e*) investments acquired and intended to be retained for trade purposes

Where practicable, fixed assets in existence at the date of the Balance Sheet should be shown at cost and the aggregate of the provisions for depreciation and for diminution in values up to that date should appear as deductions therefrom

Shares in and Amounts Owing from Subsidiary Undertakings

In addition to the aggregate amount of shares in, and the aggregate amount

owing from subsidiary companies which must be stated separately in accordance with the Companies Act 1929 the aggregate amount owing from sub subsidiary companies should also be stated The aggregate amounts owing from subsidiary and sub subsidiary companies may be shown under fixed assets current assets or as a separate group according to their nature

Note —In the Balance Sheets of subsidiary and of sub subsidiary companies the aggregate amount of shares in and the aggregate amounts owing to and from the ultimate holding company and its subsidiary undertakings should be stated separately

Current Assets

In this group should be included such assets as are held for realization in the ordinary course of business They should be stated separately in appropriate sequence and normally include (*a*) stock in trade and work in progress (*b*) trade and other debtors prepayments and bills receivable (*c*) investments held as part of the liquid resources of the company (*d*) tax reserve certificates (*e*) bank balances and cash

Note —Debts of material amount not due until after the lapse of one year from the date of the Balance Sheet should be separately grouped and suitably described

Preliminary and Issue Expenses, etc

In this group should be included particulars and amounts of expenditure such as preliminary expenses issue expenses and discount on capital issues not written off

PROFIT AND LOSS ACCOUNT

The Profit and Loss Account should be presented in such a form as to give a clear disclosure of the results of the period and the amount available for appropriation for which purpose it may conveniently be divided into sections

Such a disclosure implies substantial uniformity in the accounting principles applied as between successive accounting periods any change of a material nature such as a variation in the basis of stock valuation or in the method of providing for depreciation or taxation should be disclosed if its effect distorts the results The account should disclose any material respects in which it includes extraneous or non recurrent items or those of an exceptional nature and should also refer to the omission of any item relative to, or the inclusion of any item not relative to the results of the period

However much supplemental detail of the trading results may be given the following items should be stated separately in addition to those required by Statute—

(*a*) Income (gross) from investments in subsidiary undertakings

Note —The treatment of income from subsidiary undertakings will depend on the nature of their relations with the holding company and on whether a Consolidated Profit and Loss Account is submitted Where for any reason a Consolidated Profit and Loss Account is not submitted income from subsidiary undertakings should be shown separately unless the trading with the holding company is so interlocked that such separate disclosure might create a misleading impression If a Consolidated Profit and Loss Account is submitted, it should disclose as a minimum the items referred to below relative to the group as a whole

(*b*) Income (gross) from other investments

(*c*) Depreciation and amortization of fixed assets

(*d*) Interest charges (gross) on debentures and long term liabilities

(*e*) Credits or charges in respect of provisions other than those for specific requirements the amounts whereof can be estimated closely (See Recommendation No VI)

(*f*) National defence contribution or excess profits tax, showing separately, if material credits or charges in respect of earlier periods

(*g*) Credits or charges if material in amount, which are abnormal in nature or relate to previous periods

(*h*) Income tax and the basis thereof, showing separately if material credits or charges in respect of earlier periods (See Recommendation No III)

(*i*) Amounts set aside for redemption of share and loan capital

(*j*) Reserves made or withdrawn (See Recommendation No VI)

(*k*) Dividends paid or proposed showing under a separate heading those which are subject to confirmation by the shareholders

(*l*) Balances brought in and carried forward

COMPARATIVE FIGURES

Comparative figures of the previous period (prepared on the same basis as those for the period under review) should be given both in the Balance Sheet and in the Profit and Loss Account

DISCLOSURE OF INFORMATION

If directors of a company desire to disclose in their report information which but for its inclusion in the report, would be required to be disclosed in the accounts the relative paragraphs in the report should be clearly distinguished from the remainder of the report and specifically referred to in the accounts

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